SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 1410

MIDWESTERN GAS TRANSMISSION COMPANY, EAST TENNESSEE NATURAL GAS COMPANY, *Petitioners*,

v.

FEDERAL POWER COMMISSION, ET AL., *Respondents*.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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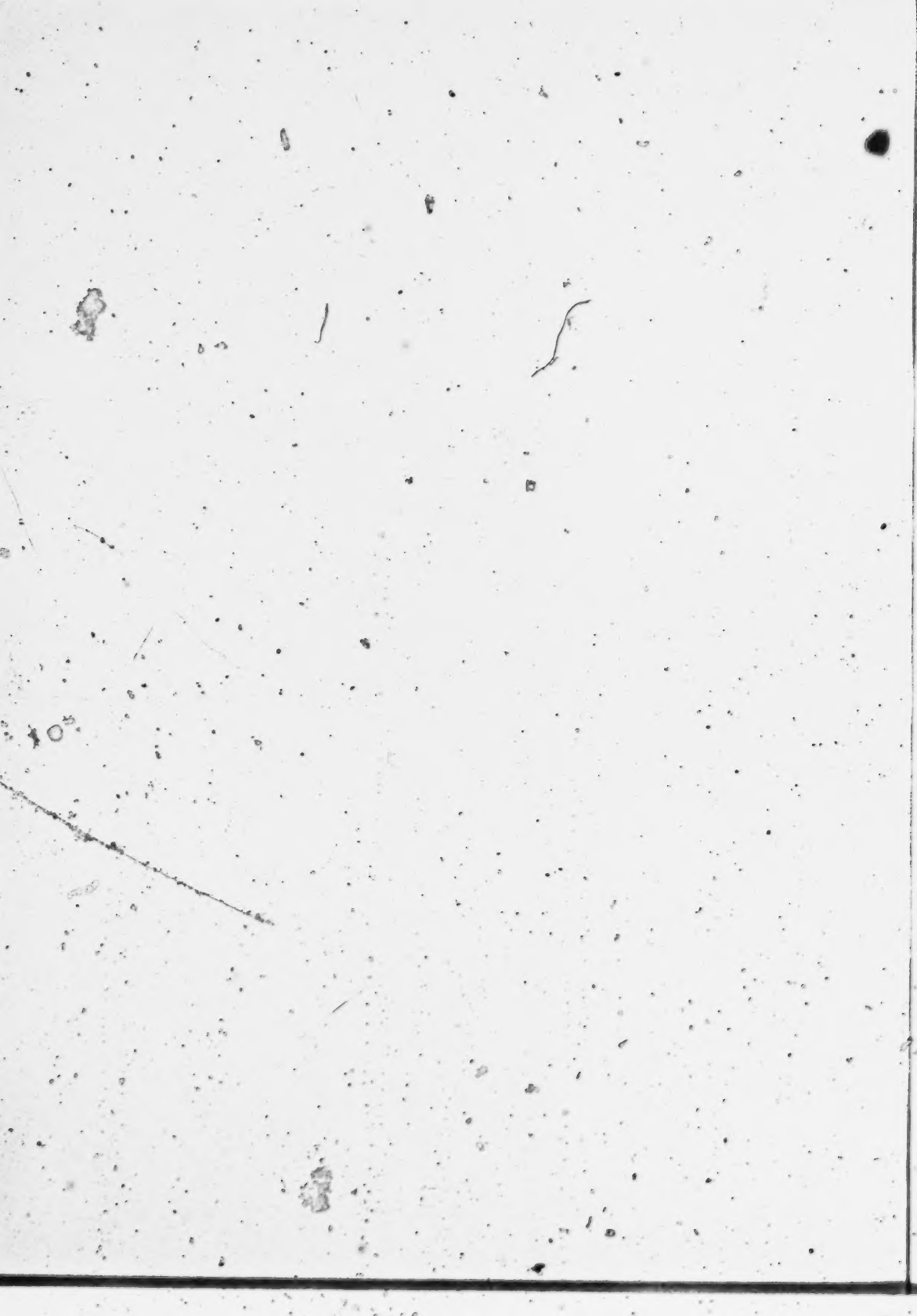

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APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

OPINION OF FEDERAL POWER COMMISSION

Opinion No. 497

OPINION AND ORDER ON PROPER RATE TREATMENT OF AVAILABLE LIBERALIZED DEPRECIATION TAX DEDUCTIONS.

(Issued July 15, 1966)

BLACK, Commissioner:

Introduction

The issue in this proceeding is whether the Commission, in the exercise of its ratemaking authority, may base the Federal income tax allowance in a pipeline's cost-of-service

on the higher depreciation deductions and lower taxes available under the liberalized depreciation tax option provided in Section 167 of the Internal Revenue Code irrespective of the actual deductions taken by the company in its Federal income tax returns. Stated otherwise, and relating the issue to the facts in the cases now before us, the question presented is: Where a pipeline, having once decided to receive the benefits of liberalized tax depreciation, thereafter elects to revert to straight-line depreciation and pays Federal income taxes based thereon, such amount being in excess of the tax payment which would otherwise have been incurred under liberalized depreciation, is the Commission bound to accept the depreciation method so selected or may it in appropriate circumstances compute a tax depreciation allowance based on a method resulting in a lesser cost-of-service and lower rates to the pipeline's customers?

The issue above stated has not previously been ruled upon by the Commission. The present proceeding was initiated by an order issued April 21, 1965, for further hearing on this question as remanded in Opinion No. 444,[1] for the purpose of affording Midwestern Gas Transmission Company (Midwestern) an opportunity to justify its action in 1964 in dropping liberalized depreciation and switching to the use of straight-line depreciation for its Federal income tax returns. An identical issue involving East Tennessee Natural Gas Company (East Tennessee) subsequently was severed from the rate proceedings otherwise determined in Opinion No. 488,[2] and was consolidated with the deferred issue in the *Midwestern* case. Both Midwestern and East Tennessee are now operating under rates which reflect the higher taxes payable under the straight-

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[1] *Midwestern Gas Transmission Co.*, issued October 13, 1964, 32 FPC 993.

[2] *Knoxville Utilities Board, et al.* v. *East Tennessee Natural Gas Co.*, issued April 19, 1966, 36 FPC—.

line method of depreciation, subject to reduction in the event that we determine that the rates should reflect the use of liberalized depreciation even though the companies use straight-line depreciation for tax purposes.[3] The issue is presented to us for decision on exceptions to (1) Examiner William C. Levy's decision of January 11, 1966, which would require Midwestern to compute its tax allowance on the basis of liberalized depreciation beginning in 1966, and (2) Examiner Seymour Wenner's decision of August 23, 1965, wherein he computed the test period cost-of-service of East Tennessee as though it were continuing to take liberalized depreciation.

Midwestern and East Tennessee filed exceptions to the Examiners' recommended determinations. In the *Midwestern* case, staff, the City of Chicago and the American Public Gas Association support the required use of liberalized depreciation, disagreeing with the Examiner only as to the method to be applied in determining the amount of the reduction. The Independent Natural Gas Association of America (INGAA), an intervener, upholds the position of Midwestern and, indirectly, East Tennessee. In the *East Tennessee* case, the initial decision is supported by a number of distributor customers—Knoxville, *et al.*, Chattanooga, Roanoke and Colonial—and the staff. Pursuant to requests of the parties, oral argument was held before the full Commission on April 5, 1966.

The additional revenues required by Midwestern and East Tennessee as a result of their elections to drop liberalized depreciation in favor of straight-line depreciation have been computed in the appendices to this Opinion. As therein determined, Midwestern's decision has served to add $546,960 annually to its cost-of-service to be recovered in the rates charged its customers, while East Tennessee's

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[3] Opinion No. 444, Ordering Paragraph (D), 32 FPC at p. 1005, and Order Approving Proposed Settlement, issued December 30, 1964, 32 FPC 1548; Opinion No. 488, mimeo. p. 6.

cost-of-service has been increased by an average of $374,312.[4]

Tax Depreciation Practices Permitted by the Internal Revenue Code

Section 167 of the Internal Revenue Code provides that the taxpayer may determine his tax depreciation either by the straight-line method, the declining balance method, or certain other methods not pertinent herein. Straight-line depreciation is designed to produce a uniform annual depreciation deduction over the useful life of the asset. It is computed merely by dividing the cost of the asset, less salvage value, by the assumed service life. The declining balance depreciation method, sometimes called the double declining balance method, is one of the methods of liberalized depreciation authorized by Section 167 for taxable years beginning on or after January 1, 1954, for property constructed in 1954 or thereafter. Under the double declining balance method a uniform rate of twice the straight-line rate is applied to the unrecovered tax basis of the property, *i.e.*, the tax basis less the tax depreciation allowable in prior years. Absent a change in the tax rate, the use of declining balance tax depreciation rather than straight-line depreciation does not change substantially the total taxes to be paid over the life of a particular property; rather, it simply permits a greater tax deduction in the early life of a property than available if straight-line depreciation were taken, offset by a less than straight-line tax deduction in the later life of a property.

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[4] These amounts are based on the averaging technique set out herein. All other elements of Midwestern's cost-of-service remain as previously determined in Opinion No. 444 and the December 1964 settlement based on a test year ending June 30, 1962, as adjusted. East Tennessee's cost-of-service for all elements other than the Federal income tax allowance was fixed in Opinion No. 488 on an adjusted test year ending September 30, 1964.

We have had occasion to examine, in detail, the impact of liberalized depreciation on the natural gas pipeline industry, generally, and on one company in particular, in our recent *Alabama-Tennessee Natural Gas Company* Opinion No. 417.[5] While, as we there found, it is axiomatic that, other tax elements remaining constant, the total taxes payable with respect to each piece of depreciable property will be the same regardless of the depreciation method used, this does not mean that the tax consequences occasioned by the use of liberalized depreciation can be measured meaningfully the basis of specific assets or even on the basis of the total assets acquired by a company in any single year. Income taxes and the tax depreciation to be used as a deduction in computing the net tax are measured not on each individual asset but on the taxpayer's total depreciable assets. A utility's depreciable properties include assets of various vintages. Consequently, the less than straight-line depreciation available on older assets under liberalized depreciation tax accounting is counterbalanced by greater than straight-line depreciation on newer assets so long as the company continues the use of liberalized depreciation and continues to make capital additions equal to or exceeding the cost of replacements. Under these conditions liberalized depreciation will always exceed straight-line depreciation and the accumulations established under normalized rate and deferred tax accounting will continue to increase until the dollar value of gross plant stabilizes. Even if the composite plant of a company remains stable, where the dollar value of retirements equals the cost of replacements, annual liberalized depreciation will not be lower than straight-line depreciation, and the reserve established under the normalization will not decline. As the Court of Appeals stated in

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[5] Issued February 3, 1964, 31 FPC 208; rehearing granted for further consideration, 31 FPC 768; rehearing and stay denied, Opinion No. 417-A, 31 FPC 928.

upholding our decision, conventional accounting fails in these instances because:

> "[it] does not take into consideration the effect of applying liberalized depreciation to a utility's total assets which are, of course, subject to a continuing cycle of obsolescence and renewal. If the industry is stable or expanding, requiring the utility's continued reinvestment in plant equal to or in excess of plant retirement, a program of liberalized depreciation produces true tax savings because there is no reduction in the tax reserve fund."[6]

Decision in Alabama-Tennessee

The issue herein is an outgrowth of our decision in *Alabama-Tennessee Natural Gas Company,* Opinion No. 417. Briefly summarized, the following conclusions were reached in that case regarding the use of liberalized depreciation instead of straight-line depreciation.

1. The use of liberalized depreciation results in permanent reduction of Federal income taxes by pipelines which maintain either a growing or a stable gross plant, as opposed to a simple tax deferral.

2. Alabama-Tennessee, in particular, and the gas pipeline industry in general, will maintain a growing or stable gross plant in the foreseeable future.

3. In enacting Section 167 of the Internal Revenue Code, Congress did not specify the manner in which taxes computed thereunder by jurisdictional (regulated) companies should be treated for ratemaking purposes. Further, there is nothing in the Internal Revenue Code or its legislative history to show that Congress intended to prohibit flow-through to consumers of the tax savings resulting from the use of liberalized depreciation.

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[6] *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, No. 21610, 359 F. 2d 318, 328, (CA5, 1960), footnote omitted.

4. The prime purpose of permitting liberalized depreciation is to promote expansion in the capital goods industry. This result will best be served in the case of natural gas pipelines if the tax savings are reflected in lower rates, which will tend to generate higher sales, in turn requiring more capital facilities for gas transmission.

5. Where a pipeline is using liberalized depreciation and its gross plant is likely to be either growing or stable, its cost-of-service and rates should reflect the tax savings resulting from the use of liberalized depreciation. In other words, in these circumstances it must flow through to its customers the tax savings from liberalized depreciation.

6. No return should be allowed for the future on accumulated deferred tax balances. The pipeline are permitted, however, to continue to have the use of this capital interest free.[7]

The decision in *Alabama-Tennessee* expressly was limited to companies claiming the benefits of liberalized depreciation on their tax returns. As stated in the Opinion:

> "We do not have before us the question whether a utility which has not exercised its option to claim the tax benefits of liberalized depreciation should have

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[7] Prior to Opinion No. 417, the difference between the lower tax actually paid under liberalized depreciation and the higher normalized tax was accumulated in a deferred tax account (Account No. 282, Accumulated Deferred Income Taxes—Liberalized Depreciation) to be used to offset the higher tax payments contemplated in later years. The return on the monies so held, which had at one time been included in the rate base at a full rate of return, *Panhandle Eastern Pipe Line Co.*, Opinion No. 269, 13 FPC 53, aff'd *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC, 1955), and later at a 1½ percent return, *Northern Natural Gas Co.*, Opinion No. 342, 25 FPC 431; *Panhandle Eastern Pipe Line Co.*, 25 FPC 550 (1961), aff'd 316 F. 2d 659 CADC, 1963, cert. denied 375 U.S. 881), was reduced to zero on the ground that these balances were henceforth to be regarded as consumer-contributed capital "collected for a specific purpose of remote and improbable occurrence."

its rates fixed on the basis of the availability of such higher depreciation deductions, and nothing in this opinion should be taken as an indication of our views on that question." (31 FPC at p. 210)

Following our issuance on April 15, 1964, of Opinion No. 417-A denying rehearing, the decision in *Alabama-Tennessee* was appealed to the Court of Appeals for the Fifth Circuit. On March 25, 1966, the court issued its unanimous decision[8] affirming the Commission in all respects. Among its other holdings, the court rejected the argument that Opinion No. 417 conflicted with the intent of Congress as expressed in Section 167 of the Internal Revenue Code and arbitrarily deprived the company of the benefits of congressionally sanctioned liberalized depreciation, holding that the enactment of Section 167 was not intended to restrict our responsibility "to fix fair rates according to our usual ratemaking policies in favor of the consumer" nor our discretionary authority to choose between competing theories of accounting for ratemaking purposes.

The court found that our decision was supported by substantial evidence. It agreed with our finding that the use of liberalized depreciation will *always* result in tax savings rather than tax deferrals for a regulated company so long as the dollar value of the gross plant remains stable or increases. "It is true that the Commission's decision rests on a reading of the future," the court stated. "But clairvoyance is part of the daily grind of a regulatory agency. Whether flow-through or normalization is the rule, the agency must base the rule on some projection of the future. As we see it, the case for normalization requires more speculation than the case for flow-through. And it is at the expense of consumers."

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[8] *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, No. 21610, 359 F. 2d 318; petition for certiorari pending.

It is not our purpose here to reargue the merits of *Alabama-Tennessee*. Our holdings in that case are set out in full in the Opinion, and the Opinion has received the judicial sanction of the Appellate Court. The decision will be followed by us in similar cases unless it is set aside on an appeal to the Supreme Court.[9]

Before proceeding to a detailed analysis and consideration of these cases, it is worthy to note that the evidence before us in the present proceeding is similar to that relied on by the Commission and accepted by the court in the *Alabama-Tennessee* proceedings. There the intervener introduced evidence based on the historical growth pattern of Alabama-Tennessee and of the natural gas pipeline industry to show that Alabama-Tennessee was in fact a growth company whose gross plant was growing annually. In addition, evidence was offered which proved that by virtue of its growth circumstances Alabama-Tennessee would realize an actual tax savings by its use of liberalized depreciation. In the present proceedings staff and the interveners have offered similar evidence of the growth history of the parties here before us, as well as that of the natural gas pipeline industry, and have presented evidence which demonstrates that, in the circumstances, the tax consequences represent a net savings to these companies.

Depreciation Practices of Midwestern and East Tennessee

Midwestern used the declining balance depreciation method in its tax returns for the years 1959 through 1962, inclusive. The Commission's *Alabama-Tennessee* Opinion was issued February 3, 1964. This date was subsequent to the conclusion of the hearings in the then pending Section 5(a) proceeding fixing the Midwestern cost-of-service but prior to the initial decision thereon. During the test

[9] *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, No. 286, Oct. Term 1966, petition for certiorari filed June 23, 1966.

period Midwestern took full advantage of liberalized depreciation in filing its tax returns. The Examiner, relying specifically on Opinion No. 417, utilized liberalized depreciation in computing Midwestern's tax allowance.[10] His decision was issued April 29, 1964. On May 11, 1964, twelve days after the initial decision, Midwestern's board of directors adopted a resolution ordering the use of straight-line depreciation for its Federal tax returns effective as of January 1, 1963.[11] In Opinion No. 444 we determined that Midwestern should "be given an opportunity to present evidence to show why it has changed to straight-line depreciation, how the use of liberalized depreciation in computing taxes for ratemaking purpose might adversely affect its interests, the effect of its change to straight-line depreciation in the rates to be charged consumers *vis-a-vis* the Commission's determination in Opinion No. 417, [and] the method to be used in applying accumulated deferred taxes against its increased tax costs and other relevant facts."

It may be noted at this point that there is no issue herein as such as to the application of the reserve accumulated by Midwestern for deferred taxes or the deduction thereof from the rate base. Pursuant to a December 1964 settlement,[12] Midwestern has refunded to its customers the full amount of the reserve ($3,569,600) accumulated

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[10] 32 FPC 1012, at p. 1062.

[11] Section 167(e)(1) of the Internal Revenue Code permits a taxpayer to change at any time from the declining balance depreciation method to the straight-line method without obtaining consent of Internal Revenue. The converse is not true; once the taxpayer elects to go from liberalized to straight-line, consent is necessary to effect a reversion. Internal Revenue has ruled that such consent cannot be granted retroactively (Exhibit R-1).

[12] 32 FPC 1548. The settlement approved all contested cost-of-service items other than the reserved depreciation issue.

during the years it utilized liberalized depreciation.[13] Moreover, the proper treatment of these past accumulations is not at issue in this proceeding but is the subject of a pending notice of rulemaking in Docket No. R-264,[14] action on which has been deferred to this time pending judicial affirmance of our decision in *Alabama-Tennessee*.

East Tennessee's situation parallels in many ways that of Midwestern. East Tennessee had been using liberalized depreciation since 1954. In December 1964, after commencement of the proceedings in Docket No. RP65-4, its board of directors ordered the conversion to straight-line depreciation. East Tennessee filed its 1964 tax return on

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[13] Midwestern's action in refunding this amount to its customers was part of the total package of considerations underlying the settlement agreement. In Opinion No. 417, 31 FPC at p. 220, we sought to encourage companies that have taken liberalized depreciation in the past to pay back the accumulated reserves to their customers if they concurred in our conclusion that they would sustain no injury but did not so require; those companies wishing to maintain the fund (without any return being based thereon), as a protection against the unlikely event of increased taxes, were expressly permitted to do so. It is pertinent to note in this connection that Midwestern has at no time been required, by the settlement terms or otherwise, to reduce its rates to reflect the tax saving which it realized as a result of making the refund.

[14] 29 F.R. 9723; order denying motions, 32 FPC 803, 29 F.R. 13119. The Commission has proposed the amendment of the Uniform System of Accounts and the Annual Report forms for electric and natural gas pipeline companies so as to specify a requirement for actual tax expense accounting. The proposal also provides that accumulated deferred tax balances may be maintained intact in the present account if it is retained by the regulated company in order to offset possible future increases in actual tax liabilities stemming from the use of liberalized depreciation in earlier years. The accounts previously established for the normalization of such tax benefits would continue in the proposed accounting system for the use of such companies who can show that their gross plant investment is neither growing nor stable and would thus be authorized to continue the use of such accounts.

this basis and, like Midwestern, any future change can only be made prospectively with the approval of the Commissioner of Internal Revenue. In Opinion No. 488 we stated that we would, "for the interim, compute East Tennessee's cost-of-service tax allowance on the basis of straight-line depreciation with a condition requiring additional rate reductions in the event liberalized depreciation is found appropriate in the decision in the consolidated proceedings."[15]

Arguments By Midwestern and East Tennessee Favoring Changeover

Midwestern contends basically that its decision to change its depreciation practice from liberalized to straight-line depreciation was reasonable in the considered judgment of its directors and that the Commission is required to accept that judgment for regulatory purposes. It further contends that the Examiner erred in holding that its action "frustrates the policy of Alabama-Tennessee", which case, it points out, was limited solely to the situation of a company taking liberalized depreciation at the time of our final decision. It also argues that the claims of the parties favoring liberalized depreciation and the Examiner's decision conflict with the holdings of the *Wisconsin-Michigan* and *United Gas Pipe Line* cases,[16] as well as certain state regulatory decisions.

Both in its briefs and in the oral argument Midwestern has pointed out a variety of alleged substantial adverse effects it would suffer from a requirement of flow-through. These include the potential future tax increase argument (*i.e.*, that use of liberalized depreciation results only in a deferral, not a savings of taxes); the fact that it is in close competition with other systems having significantly

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[15] Footnote 2, *supra*, mimeo p. 6.

[16] *United Gas Pipe Line Co.*, Opinion No. 428, 31 FPC 1180 (1964); *Wisconsin Michigan Power Co.*, 31 FPC 1445 (1964).

lower rates and that no substantial increase in sales is projected; that its past sales growth has been entirely in the area of normal build-up following certification and cannot be taken as indicative of its future sales growth or of its need for new plant additions; that the tax depreciation deduction used in the Examiner's initial decision in April 1964 substantially exceeds the comparable straight-line depreciation deduction available to it, with the result that the continued use of liberalized depreciation would have required rate increases of approximately $1,000,000 in 1965 and $270,000 each year thereafter in order to offset the annual increase in taxes resulting from the decreasing depreciation tax deductions; that the reduction in the tax component of the cost-of-service is more than offset by other recent cost increases (gas purchase costs, wages, materials, etc.); that its past and expected future plant growth rate are small, differing substantially from the industry average while, because of the newness of its plant and the consequent greater rate of annual decline in tax depreciation than for plants of older vintage, its rate of plant additions would have to be above the industry average to maintain the same annual liberalized depreciation tax deductions; and that its bond coverages would be reduced with flow-through, impairing its ability to issue new securities.

Finally, Midwestern claims that the "assumed minimal future average" plant additions of 1.5 percent per year for the years 1966-1970 projected by the Examiner in calculating the amount of the allowed liberalized depreciation tax deduction cannot be used since they are uncertain and speculative.

East Tennessee in its exceptions reiterates Midwestern's arguments that there is no evidence to support the claim that its management's decision was unreasonable, that our holdings in the *United* and *Wisconsin Michigan* cases and the State decisions are valid precedent for permitting it to utilize straight-line depreciation, and that there is no

absolutely clear showing that it will have sufficient continuing growth in the future to offset the potential increased tax liability resulting from the use of liberalized depreciation on its entire plant. Except as otherwise necessary we shall consider these objections as they relate primarily to Midwestern, discussing East Tennessee directly only insofar as factual distinctions dictate a separate consideration.

Obligation To Reflect Available Savings

As noted by Examiner Wenner in his initial decision in *East Tennessee,* we are not here deciding how Midwestern and East Tennessee shall compute their Federal income taxes. The companies are, of course, free to elect their own method for such filings but, realistically, we would not expect the companies to continue the use of straight-line depreciation. The issue is whether the increased tax payments resulting from the decision to discontinue use of liberalized depreciation is a reasonable and prudent business expense which the customers may properly be required to bear. Paraphrased, the issue is whether Midwestern and East Tennessee are fulfilling their duties under the Natural Gas Act when they voluntarily take an action of the character here involved, which will necessarily have the effect of substantially raising their costs and rates. For the reasons advanced in this proceeding, we hold that they are not.

An elementary proposition of utility law and utility regulation, universally recognized, is that public utilities, in the interest of their customers as well as in their own interest, should be permitted to charge rates which are compensatory of the full cost incurred by alert, efficient, and responsible management. It is equally elementary that customers should not be required to pay more than this cost. As stated by the Supreme Court:

> "The contention is made that the amount to be expended for these purposes is purely a question of

managerial judgment. But this overlooks the consideration that the charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any purposes." *Acker* v. *United States,* 298 U.S. 426, 430-431 (1935).

This requirement to utilize all available cost saving opportunities is applicable to tax savings as well as general economies of management, *El Paso Natural Gas Co.* v. *F.P.C.,* 281 F.2d 567, 573 (CA5, 1960).

It is neither our purpose nor our desire to dictate every phase of the operating practices of the natural gas companies coming within our jurisdiction. The Commission has no authority either to conduct or supervise the day-by-day operations involved in the production and transportation of natural gas in interstate commerce. Those functions are left to management for decision and the managers exercise a broad area of discretion in the conduct of their business affairs. In the exercise of the authority conferred upon us by the Natural Gas Act, our function is to review those business judgments to assure they do not impair and are consistent with the concomitant obligation of management to make available the natural gas supplies needed by the consuming public at the lowest reasonable rates consistent with the public interest.[17]

Managements of unregulated business subject to the free interplay of competitive forces have no alternative to efficiency. If they are to remain competitive, they must constantly be on the lookout for cost economies and cost savings. Public utility management, on the other hand, does not have quite the same incentive. Regulation must make sure that the costs incurred in the rendition of the

[17] Natural Gas Act, Section 1, 15 U.S.C. Sec. 717(a); *Hope Natural Gas Co.* v. *F.P.C.,* 320 U.S. 591 (1944); *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954).

service requested are necessary and prudent. Basically, unless an abuse of discretion is shown, expenses incurred in the rendition of the service are primarily a matter of managerial judgment. This does not mean, however, that extravagant and unnecessary costs can be imposed on the ratepayers, no matter how convinced management may have been that those costs were necessary in its own interest. *Acker* v. *U. S., supra.*

Since the reviewing of rates charged by jurisdictional companies, and their adjustment when necessary, is one of our primary responsibilities, and since rates, under our original cost-rate base mode of regulation, are based on costs, it was necessary, early in the life of the Commission, to set up what has come to be known as the Uniform System of Accounts for companies subject to the provisions of the Natural Gas Act. Under this system the Commission has long exercised its responsibility to scrutinize the costs recorded by the companies and, where a cost claimed bears no reasonable, functional relationship to the provision of the service for which the rate is to be charged, to disallow the cost.

INGAA and the pipeline companies argue that the exercise of regulatory authority over operating costs amounts to a confusion of regulation with management or, as variously described, an invasion of "management prerogatives", "managerial discretion", and "management responsibilities". Managerial decisions relating to the implementation of Federal tax policies differ in nature from those pertinent to general pipeline operations. The Federal tax policy clearly encourages taxpayers to avail themselves of all lawful means for reducing their Federal tax liability and, absent a clear declaration to the contrary, the consumer is entitled to share in the Federal tax benefits allowed public utilities. In these circumstances our expertise necessarily encompasses evaluation of managerial decisions relating to the use of Federal tax benefits

available for reducing the utilities' general Federal tax liability.

Just as there are areas where regulation should not interfere, so are there areas where the Commission must apply its judgment in the performance of its obligation to protect the public interest.[18] It is here that regulation must appraise and be prepared to guide and restrain management's judgment—in the same sense that competition in the free market area guides and restrains managerial judgments in business not subject to regulation.

A wholly valid argument is made that regulation must not engage in a reconsideration of every operating decision made by management and that the substitution of the regulatory agency's judgment for that of management on every disputed operating item can only stultify the normal performance of the management function. We agree. Regulation must act with restraint in seeking to substitute the regulator's views for that of management on matters of operational policy. But regulation is reduced to an exercise in futility if it is barred or bars itself from a review of management claims for the recovery of costs running into millions of dollars solely because "management has exercised its judgment."[19]

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[18] *Atlantic Refining Co.* v. *F.P.C.*, 360 U.S. 378, 79 S. Ct. 1246 (1956).

[19] The Statistics for Interstate Natural Gas Pipeline Companies reveal that $47,850,000 in deferred tax monies was accrued by all Class A and B pipelines in the year 1963. This amount, if flowed-through to the consumers in 1963, would have resulted in an industry-wide rate reduction of approximately $100 million. The accumulations for 1961 and 1962 were $50.7 million and $53 million, respectively. More recent compilations show further gross accumulations of $38 million in 1964 and $35.6 million in 1965. Thus, the accumulation of these deferred taxes by the pipelines has resulted in the collection of more than $450 million of additional revenues in the years 1961-1965.

TAX BENEFITS AS COST SAVINGS

Under accepted regulatory practice, taxes, including income taxes, are treated as necessary operating costs to be recovered in the rates charged the users of the public utility service. *Galveston Electric Co.* v. *Galveston*, 258 U.S. 388. In this regard the utility company serves as little more than a tax-collecting conduit between the users of the service and the taxing authority. As recoverable costs, tax payments necessarily come under regulatory scrutiny and, where the level of those payments is affected by managerial action, they necessarily fall within the ambit of regulatory authority.

Midwestern has stated that it knows of no case which indicates that a regulatory commission may depart for rate-making purposes from the tax deduction shown in a company's Federal income tax return.[20] It concludes that the Examiner erred, therefore, in holding that it must justify its reversion to straight-line depreciation. Midwestern recognizes that cases dealing with situations where commissions have disregarded a company's actual debt ratio and the tax deductions claimed in its tax return for interest expense are particularly apt. It cites the case of *Re Diamond State Tel. Co.*, 48 Del. 317, 350, 103 A. 2d 304, 324 (1954), for its thesis that a commission is bound by the judgment of a company's management on these matters and can impute hypothetical tax deductions only upon a showing of a gross abuse of discretion. As noted by staff, Midwestern fails to recognize that *Diamond State* and the

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[20] See, however, *Re Bangor Hydro-Electric Co.*, 26 PUR 3d 489 (Me. PUC, 1958) and *New York State Water Service Corp.* v. *Public Service Comm.*, 37 PUR 3d 442, 208 N.Y.S. 2d 857. *Cf.*, *United Fuel Gas Co.* v. *P.S.C. of W. Va.*, 46 PUR 3d 118 (P.S.C. of W. Va., 1962), petition for review denied, *United Fuel Gas Co.* v. *P.S.C. of W. Va.*, (S. Ct. of App. of W. Va., May 20, 1963 and May 29, 1963), appeal dismissed for want of a substantial Federal question, 376 U.S. 784.

other cases on which it relies[21] represent a view which has been squarely repudiated by the decisions of many State courts wherein they have allowed income taxes and the costs of capital to be fixed on an ideal debt-to-equity ratio as determined proper by the Commission over the companies' objections that managerial discretion was being unlawfully invaded.[22]

In *C. & P. Tel. Co.* v. *Maryland Public Service Commission*, 97 PUR (NS) 50, 93 A. 2d 249 (1952), the State commission disregarded the actual interest expense shown on the company's tax return and imputed to it the higher tax deductions it would have enjoyed if it had the same capital structure as the Bell System, taken as a whole. In rejecting the company's claim that the Commission's action unlawfully invaded its management responsibilities, the court stated:

> "The company says that the adjustment invaded the prerogative of a sound, honest, and competent management and that the commission could properly make the

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[21] Brief on Exceptions, fn. 4.

[22] *Alabama* v. *Southern Bell Tel. & Tel. Co.*, 47 PUR 3d 65, 67, 148 So. 2d 229 (1962); *Re Mountain States Tel. & Tel. Co.*, 8 PUR 3d 265, 273, 284 P. 2d 681 (1955); *La Salle Telephone Co.* v. *Louisiana Public Service Commission*, 51 PUR 3d 183, 157 So. 2d 455 (1963); *Chesapeake & Potomac Telephone Co.* v. *Public Service Commission*, 97 PUR (NS) 50, 93 A. 2d 249 (1952); *New England Tel. & Tel. Co.* v. *Massachusetts Department of Public Utilities*, 6 PUR 3d 65, 74-75, 121 NE 2d 896 (1954); *New England Tel. & Tel. Co.* v. *Department of Public Utilities*, 88 PUR (NS) 73, 82, 97 NE 2d 509 (1951); *Southern Bell Tel. & Tel. Co.* v. *Mississippi Public Service Commission*, 29 PUR 3d 417, 456-457, 113 So. 2d 622 (1959); *New England Tel. & Tel. Co.* v. *State of New Hampshire*, 44 PUR 3d 498, 505, 183 A. 2d 237 (1962); *New Mexico State Corporation Commission* v. *Mountain States Tel. & Tel. Co.*, 4 PUR 3d 33, 270 P. 2d 685 (1954); *Riverton Consolidated Water Co.* v. *Pennsylvania Public Utilities Commission*, 24 PUR 3d 9, 16-17, 140 A. 2d 114 (1958); *Re New England Telephone & Telegraph Co.*, 90 PUR (NS) 414, 430-431, 80 A. 2d 671 (1951).

adjustment only on a finding of abuse of discretion, bad faith, or wastefulness. It says the commission is deciding what only the directors of the company could decide—the proper corporate structure.

"We think the commission was justified in its action. The owner and manager of the company have the right to determine what its debt-equity ratio should be, but they may not always make the rate-payers foot the bill resulting from the choice. There was no legal need for the company to pay more than its proportionate share of the joint tax liability. It has not shown any reason or necessity for its assumption of a tax liability greater than it owed or any particular consideration passing to it from A.T.&T., its sole owner, for contributing a gift to that owner."

Whatever may be the prevailing view of the States, the precedent of this Commission is clear. In the *Safe Harbor* case, in setting the rate of return, we rejected the company's actual cost of capital on the basis that the company could have substantially reduced its interest expenses by refinancing. As we there said:

"[W]here, as here, management is laggard in taking advantage of the prevailing low money rates, we have no recourse but to use proper current interest rates, rather than the excessive rate actually paid by the company. Any other treatment would be a premium on inefficiency."[28]

In the same case we also assumed an appropriate capital structure differing from the company's actual debt-ratio in our rate of return considerations. In upholding the Commission's action the Court of Appeals for the Third Circuit held that this involved considerations peculiarly within the administrative capacity of the Commission which

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[28] *Safe Harbor Water Power Corporation*, 5 FPC 221, 260.

were supported by substantial evidence, but, that "[W]ere we reviewing the matter *de novo* we would reach the same conclusions as those expressed by the Commission."[24]

Midwestern cites *City of Pittsburgh* v. *Pennsylvania Public Utility Commission*, 25 PUR 3d 273, 144 A. 2d 648 (1958), where the Pennsylvania Superior Court affirmed a State commission ruling that the choice under the tax laws between liberalized and straight-line depreciation belongs exclusively to the company and could not be overthrown by the regulatory agency. However, unlike the conclusions reached by this Commission in Opinion 417, the Pennsylvania Commission had not made any finding to the effect that the use of liberalized depreciation by a growing utility results in a permanent tax reduction. It was in this context that the Pennsylvania courts held that where a utility has the option by law to take or not to take liberalized depreciation, the exercise of that option cannot constitute an abuse of discretion.

In *Alabama-Tennessee* we rejected a related argument advanced by the Tennessee Valley Municipal Gas Association. It contended it would be an abuse of our discretion to allow anything more than the dollar total of taxes actually paid by Alabama-Tennessee in the test year. In denying this argument we stated:

"... These parties have erred in equating current taxes paid during the test year with the taxes properly al-

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[24] *Safe Harbor Water Power Corporation*, 179 F. 2d 179, pages 200-201, 3d Circuit, cert. denied 339 U.S. 957 (1950). The Commission also used an assumed capital structure it considered appropriate without respect to the actual capital structure of the company in its rate of return evaluation in *South Carolina Generating Co.*, 16 FPC 52, remanded 249 F. 2d 755; 19 FPC 855, remanded on other grounds 261 F. 2d 915. We have also required the submission of amended financing plans when the plan proposed has included too thin an equity base. *Houston Texas Gas & Oil Corp.*, Opinion No. 301, 16 FPC 118, 140-141; *Permian Basin Pipeline Co., et al.*, Opinion No. 249, 12 FPC 85, 93.

lowable for rate-making purposes. Income tax allowances have never been mechanically geared to test year tax expenses. On the contrary, past tax expenses are significant only insofar as they constitute a guide to recurring tax obligations. Deferred taxes are merely one example of rate adjustments designed to normalize the actual taxes of the test year.

"The assertion that this Commission as a matter of law can recognize only currently payable taxes regardless of the factual circumstances runs afoul of the relevant Court decisions which establish that the rate treatment of liberalized depreciation is a matter of administrative discretion."

In our opinion, the same reasoning applies equally in the determination whether, in the converse situation, we may recognize a tax allowance based on hypothetical liberalized depreciation where a company is actually taking straight-line depreciation. The court's decision upholding our *Alabama-Tennessee* ruling both enforces our conclusion that this is a proper area for Commission review and removes any remaining doubt that we are in any way controlled in our ratemaking authority by the fact of the Federally created tax option.

In *El Paso, supra,* the court rejected El Paso's argument that the requirement for flowing through optional tax benefits under the liberalized depreciation provisions of the Internal Revenue Code was inconsistent with the intent of Congress, holding:

"The requirement that the Commission determine a just and reasonable rate is not modified by reading into the statute an exception to the extent that the prices charged may be sufficient to afford a just and reasonable rate plus an amount representing a saving in taxes granted to the gas industry . . . . We think, in short, that there is no statutory authority for the

Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost-of-service." (281 F. 2d, at p. 573)

At this juncture, and with the background of the court decisions in the *El Paso, Panhandle Eastern, City of Lexington,*[25] and *Alabama-Tennessee* cases, there is no remaining validity to the contention that the tax benefits allowed public utilities by Congress, absent a clear declaration to the contrary,[26] are for the exclusive benefit of their stockholders. Rather, the decisions show that the utilities are under a positive obligation to share with their consumers the savings resulting from the exercise of the tax options.

Validity of Claims Opposing Required Use of Liberalized Depreciation

Midwestern's arguments to the effect that we are required, for regulatory purposes, to accept the "considered judgment of its directors" in this area has already been referred to and is rejected. As we have stated, the scope of managerial discretion is wide; however, under regulation it is not plenary. We cannot overlook the fact that amounts charged in the cost-of-service as Federal income taxes are being collected from the ratepayers and that the ratepayers have a right to expect this Commission to allow, as an expense, only the amounts reasonably necessary for this and any other purpose.

In *United Gas Pipe Line Company,* Opinion No. 428, and *Wisconsin Michigan Power Company,* Opinion No. 432,

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[25] *Cities of Lexington, et al.* v. *F.P.C.*, 295 F. 2d 109 (CA5, 196).

[26] Compare the treatment accorded to investment tax credit in the 1964 Revenue Act where Congress expressly provided that regulatory agencies were not to use the credits generated under Section 38 to reduce the tax component. P.L. 88-272, Section 203(e), 78 Stat. 35.

both decided after our decision in *Alabama-Tennessee*, we declined the requests of certain interveners to compute the tax allowance on the basis of an assumed use of liberalized depreciation when the companies had always used straight-line depreciation. Midwestern and East Tennessee argue that our decision in those cases establish a precedent on our part that the Federal income tax allowance must reflect the actual taxes paid and that it would be inconsistent to allow anything less than their tax expense as determined by them under any of the several Section 167 tax options. Our holdings there were based on the failure of the proponent of compulsory flow-through to make a persuasive showing that mandatory use of liberalized depreciation methods would result in a net tax savings to those companies. In the present record we are persuaded that the initial decision of Midwestern and East Tennessee to utilize liberalized depreciations was correct and that the continued use thereof will result in tax savings to these companies.

The argument that the use of liberalized depreciation results in a tax deferral rather than a tax savings was, of course, the basic issue in the *Alabama-Tennessee* proceeding. It has been adequately answered with respect to growing or stable pipeline companies in our Opinion in that proceeding and in the court's unanimous decision upholding our position, as well as in our earlier discussion herein. The real issue, as to Midwestern and East Tennessee, is whether or not they will experience growth, stability, or a decline in their gross plants. As discussed below we find that the evidence fully supports that Midwestern will, for the future, experience minimum average plant additions of 1.5 percent per year. East Tennessee's growth prospects, averaging in excess of 4 percent per year as we here find, are not open to serious dispute. In these circumstances, as we found in our *Alabama-Tennessee* Opinion, there can be no question but that, insofar as Midwestern

and East Tennessee are concerned, their use of liberalized depreciation will result in actual savings, not merely a tax deferral.

While it is at least possible that a company taking liberalized depreciation will experience a tax increase at some indefinite time in the future, this can occur only if the dollar additions to its gross plant do not keep pace with gross plant retirements. Considering the many factors involved, including the significant increase in facility costs over the past years, we are not persuaded by the argument in the absence of a positive showing of a declining plant balance in the particular case under consideration. In the words of the Fifth Circuit in its decision in *Alabama-Tennessee*, "... the case for normalization requires more speculation than the case for flow-through. And it is at the expense of the consumers."

Midwestern notes that it is in close competition with other pipelines having significantly cheaper rates, particularly with respect to its ability to secure additional sales on its Southern System. Thus, it argues that realistically it could not seek a future rate increase to offset future increases in tax liability resulting from its flow-through of the benefits of liberalized depreciation in the event our predictions as to its plant growth are inaccurate.

By changing over to straight-line depreciation, Midwestern incurred a larger tax expense than would have been the case under continued liberalized depreciation. It took this action despite the competition in the Chicago area which it is currently experiencing. Seemingly it was not bothered by the additional expense at this time. We question, then, Midwestern's concern over its competitive circumstances at some future date when, theoretically, it will be serving customers acquired in today's market under long-term gas supply contracts.

Further, as we will discuss in detail later, the evidence in the present proceeding provides no support for Mid-

western's contention that it is in a declining plant circumstance. Assuming *arguendo* that Midwestern is correct, the City of Chicago evidence clearly shows that even with zero plant additions, without replacements, savings will be realized by the setting of rates on the basis of liberalized depreciation with flow-through for the period through 1972.[27] Under this assumption, as argued by the City of Chicago, Midwestern might then be allowed to revert its entire plant to straight-line depreciation at the beginning of 1973 if such is advantageous to it.[28] This change-over would be postponed, however, if sufficient plant additions or replacements were made in the interim to show a continuing benefit from liberalized depreciation.

Midwestern assumes that the present consumers should be obligated to underwrite higher expenses to insure Midwestern's stockholders against the uncertain contingencies of adverse competitive situations in the future. We reject the concept that consumers are guarantors of a pipeline's future earnings. We have, of course, recognized

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[27] The Chicago exhibit showed savings through 1972, but a portion of these savings are attributable to a lowered return in the later years of the period due to the assumed declining rate base.

[28] This assumes a change-over from liberalized to straight-line depreciation must occur at a single point in time for the entire plant. This is contrary to sound business practices for companies, such as gas pipelines, with assets of varying vintage and is not required under the tax laws. The law permits selective change-over with respect to individual items, groups, classifications or composite accounts at any time such change-over is advantageous to the taxpayer. It is customary for taxpayers taking liberalized depreciation to revert to straight-line depreciation as tax items age, generally at one-year past the halfway mark of the item's estimated service life. This permits the realization of the full benefits of liberalized depreciation in the early years of the asset and minimizes the rapid decline in depreciation benefits in the asset's later life. It also prevents any sudden increase in taxes when a company reverts to straight-line depreciation as tax items age.

Midwestern's highly competitive situation in our rate design in Opinion No. 477.[29] For example, its Southern System commodity rates, when the higher Btu content of Midwestern's case is considered, are equal to the commodity rates of its principal competitor, Natural Gas Pipeline Company of America. Of course, as discussed below, its basic thesis that it is not a growth company is inaccurate. In these circumstances the use of liberalized depreciation to lower Midwestern's rates will in fact be advantageous to its competitive situation. Despite the assertions regarding the minor amount of reductions in rates to be occasioned by an order requiring liberalized depreciation, we find nothing in the arguments made by the pipelines and INGAA to lead us to doubt the correctness of our conclusion, which has been so recently affirmed by the court in the *Alabama-Tennessee* proceeding.

Finally Midwestern also assumes that the proper tax allowance and the reduction in the future revenue requirements attributable thereto which we find appropriate in these proceedings are fixed and immutable for all time. The rates which we herein prescribe are those required, in our opinion, by Midwestern and East Tennessee to cover all their reasonable jurisdictional costs and to provide a fair rate of return from their operations through the ensuing few years. Whether these same rates or, for that matter, the same ratemaking treatment of the companies' tax depreciation practices, will remain in effect following our next rate review will be determined by the findings and conclusions reached at that time on the facts as then presented.

Midwestern also contends that the use of flow-through of liberalized depreciation will necessitate a rate increase to compensate for the loss of deductions in its tax computation, since it is not a growth company. It further argues that any reduction in the tax component of its cost-of-

[29] Issued September 28, 1965, 34 FPC —.

service attributable to liberalized depreciation is more than offset by other recent cost increases. In *Midwestern*, as in *East Tennessee*, the issue of the tax allowance was reserved in the rate cases fixing, for the interim, the approved cost-of-service and the parties were on notice that additional rate reductions might be required depending on the outcome of this proceeding. Whether Midwestern or East Tennessee will in fact need a rate increase for the future for expenses other than the reserved tax issue can properly be established only in the context of a new proceeding under Sections 4 or 5 of the Act. Midwestern contends that a rate increase will be necessary to offset its loss of deductions in tax computations since its net rate base has been falling. Specifically, Midwestern notes that Examiner Zwerdling's decision in April 1964 recommended the flow-through of $2,050,051 per year based on the test year experience. Midwestern is understandably concerned if its rates are set on the flow-through of the high level of tax savings experienced in the test year. But, as Examiner Levy made clear, this problem can be avoided by computing the tax savings attributable to liberalized depreciation by using the future five-year average impact of the 1.5 percent annual growth rate which the evidence establishes is appropriate. Over the period for which the rates will be applicable, the net amount of the liberalized depreciation flow-through will not exceed, in our opinion, Midwestern's experienced savings. The Midwestern exhibit offered to support its contention assumes a static plant, which as noted, is contrary to the average of their historic experience, and is contrary to our findings as to its future experience. Finally, even if Midwestern's predictions are true and the plant remains static, this will not affect their level of sales. As staff's and the City of Chicago's evidence shows, the excess earnings associated with the declining net rate base would be available to substantially offset the loss of tax deductions attributable to liberalized depreciation without impairment to their allowed rate of return.

The Examiner's discussion with regard to bond interest coverage, credit standing and continued financial integrity of Midwestern adequately disposes of the arguments related thereto, and is adopted here. It should be noted that the Commission, in approving a 6.5 percent rate of return for Midwestern at the time of its determination of the cost-of-service issues in 1964, adopted the Examiner's decision which made clear that the Commission would not be restricted in its ratemaking authority by the nature of Midwestern's bond coverage requirements.[30] As therein found, purchasers of Midwestern's bonds knew that there would be relatively low coverages at any projected rate of return which the Commission could reasonably have been expected to authorize, and the bonds carried both high interest rates and warrants for the purchase of Midwestern stock, as a consequence. Further, Midwestern's earnings circumstances have never permitted it to fully comply with these restrictive coverage requirements[31] and, as staff points out, the use of flow-through in lieu of deferral has only a limited impact on Midwestern's ability to meet these coverage requirements.

Midwestern and East Tennessee argue that if required to adopt the use of liberalized depreciation, and flow-through the benefits resulting therefrom, they will require a higher overall rate of return in order to attract all necessary capital. In Opinions 444 and 488 we set 6.5 percent as the appropriate overall rate of return for these companies. We find nothing in the present record which would justify

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[30] *Midwestern Gas Transmission Co.*, Opinion No. 444, 32 FPC 993, 998-1001, 1006. For examiner's decision, see 32 FPC at pp. 1052-1053.

[31] Staff's reply brief, appendix 2, shows that Midwestern has never succeeded in meeting the first and second coverage requirements. The third coverage requirement has been met only twice, in 1962 and 1964, when the company had excessive earnings.

our reopening that issue, or cause us to approve a higher rate of return for these companies.

Staff excepted to the Examiner's failure to find that Midwestern's gross plant will grow at an annual rate of seven percent, consistent with the industry average in the ten-year period from 1954 to 1963. In its brief opposing staff's exception, INGAA argues that the record data does not establish an industry growth rate of seven percent and also alleges that an analysis of the same data reveals a drastic down-trend in the growth rate of the pipelines in recent years. Thus, it states, "While the compound growth rate for the 40-company group for the 10-year period 1954-1963 is 7.1%, the sample growth from 1960 forward has trended downward from 10.9% to 4% in 1963. Moreover, the growth rate on gross plant in 1964 was reduced to a mere 2.3%."

Although our primary concern, for the purpose of this Opinion, is with the anticipated growth of Midwestern and East Tennessee, rather than the industry as a whole, it should be noted that the 2.3 percent growth rate developed by INGAA does not provide a true picture. This is so far the reason that among the companies included in the sample is The Ohio Fuel Gas Company which in 1964 divested itself of $187,144,000 in distribution plant facilities. Reflecting this amount in the plant figures shows a growth of 5.2 percent over the previous year, which is an increase over the 1963 rate.

Prospects For Growth

As noted, the central thesis underlying Midwestern's objections to the flow-through of the benefits of liberalized depreciation is its contention that it is not a growth company. East Tennessee similarly contends that their anticipated level of growth is not adequate to justify the flow-through of the benefits of liberalized depreciation in establishing their rates. In the *Alabama-Tennessee* pro-

ceeding we held to the effect that liberalized depreciation results in permanent tax savings for stable or growing companies and that before requiring a company using liberalized depreciation to reflect such tax savings in its rates, a finding was required that the company or companies concerned would maintain a growing or stable plant for the foreseeable future. In upholding our finding, the court noted that it is sufficient if the decision "is based on substantial evidence of present conditions. . . . If the Commission is wrong, the pipelines will still have paid only actual taxes; these will be recouped in full as part of the cost of service." The court went on to note that should the future support the Commission's evaluation "and should normalization be allowed, consumers will have made enormous contributions to the pipelines' capital funds at no costs to the pipelines." Accordingly, it is necessary to estimate reasonably the growth potentialities of Midwestern and East Tennessee in order to determine both if they will realize permanent tax savings from the taking of liberalized depreciation and to fix the amount of the tax allowance to be included in the cost-of-service.

Midwestern relies on the fact that its past plant growth was only .28 percent between 1962 and 1964. We note, however, in 1966 Midwestern has committed itself to an investment of $8 million in new plant and that its historical average annual rate of growth was 2.075 percent from 1961 through 1966. This comports largely with admissions by a Midwestern witness during the hearing. For example, for the year 1966, the witness testified that gross plant additions would be made in an amount of $22,573,343.[32] Midwestern, in its initial brief to the Examiner, described this witness' testimony as supporting an estimated average

[32] Since that time filings have been made with the Commission seeking authorization for these facilities. See Docket Nos. CP66-119 and CP63-80. As discussed hereafter, we do not rely on the $14 million of facilities in Docket No. CP66-119 for the purposes of our decision herein.

annual growth of 1.5 percent per year over the 5-year period beginning October 1, 1965.[33] Despite this modest rate of growth in net plant, as staff evidence shows, Midwestern has experienced a consistent increase in its annual and peak day sales. Thus, the deliveries on Midwestern's Southern System in 1960, the first full year of operation, were 94,201,000 Mcf. By 1964 the yearly volume had arisen to 139,667,000 Mcf, an average annual increase of 12.03 percent. Northern System deliveries have gone from 49,138,000 Mcf in 1961, the first year, to 73,365,000 Mcf in 1964, an average annual growth in sales of 6.89 percent. Peak day sales for both systems increased from 572,762 Mcf in 1961 to 631,701 Mcf in 1964, an average yearly increase of 3.43 percent.

The argument is made by Midwestern that its past sales growth constitutes a normal buildup following certification and is not a valid indication of its future sales growth or of its need for new plant additions. It is correct that both of Midwestern's systems have been in their developmental phase. Consequently there has been little increase over the gross plant initially constructed in 1959 and 1960. But, as the Examiner properly notes, this past history is of little value since Midwestern, when constructed, had substantial excess capacity and is only now reaching the limits of its physical plant capacity. Thus, assuming that its future rate of growth in sales increases only at the same rate as in the past Midwestern would be required to increase the capacity of its present plant by at least 3.4 percent each year.

An analysis of Midwestern's Form 2 filings for the years 1960 through 1965 reveals that the Southern System sales have in fact grown substantially over the years. The markets which formed the basis for the certification of the

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[33] Midwestern's brief to the Examiner, RP61-19, *et al.*, pages 35 and 36.

system in 1959 (Opinion No. 320, 21 FPC 653) consisted of Northern Illinois Gas Co., where the contract demand was for 60,000 Mcf per day for the term of the contract, a maximum of 100,000 Mcf per day to Peoples Gas Light and Coke Co., and a maximum of 200,000 Mcf per day to Northern Indiana Public Service Co. (NIPSCO).[34] In 1963, the contract demand of Northern Illinois was raised to 100,000 Mcf per day. Further, Midwestern sells additional volumes of gas to these customers under other rate schedules. Finally, the Form 2's show that Midwestern has picked up new customers since 1960, at least six of whom were added in its Southern System since 1963. For these reasons we cannot agree with the argument that Midwestern's past sales growth is solely the "natural buildup following certification."

Furthermore, Midwestern services the Southern and Western segments of the Great Lakes megalopolis which has and will continue to experience a significant growth in population, general economy and energy requirements. Recognizing the rich potential of these markets, staff's assumptions are modest. Of course, we cannot accept staff's reliance on uncertificated facilities pending before us in competitive proceedings but we agree that the pendency of such applications is valid evidence of Midwestern's growth potential. Thus, while we believe that the staff prediction of a future plant growth rate of 7 percent is not unrealistic, we shall, for the purpose of our decision, use the much more conservative growth rate for Midwestern of 1.5 percent on an average annual basis.

The Examiner, in ruling that Midwestern should use liberalized depreciation in computing its tax expense for ratemaking purposes beginning January 1, 1966, based his tax saving on the average of what he concluded Midwestern

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[34] Opinion No. 320, 21 FPC 657. The Opinion states that the sales were to be made at a load factor of 83⅓ percent.

will experience in plant growth and depreciation deductions for the five-year period 1966-1970 following the resumption of liberalized depreciation. The five-year average was predicated, in turn, on Midwestern's recently certificated additional sales authorizations and certain pending applications[35] and an assumed minimal future average annual growth rate of 1.5 percent. We shall here adjust the level of plant additions used by the Examiner for 1966 to eliminate consideration of the $14 million of facilities pending before us in the *Great Lakes* competitive proceeding, Docket Nos. CP66-110, *et al.*, as well as the non-depreciable share of its underground storage project.[36]

All in all there is little, if any, support for Midwestern's forecast of a no-growth situation. Considering the particular circumstances of this case, we believe that the Examiner's estimate of Midwestern's future plant growth, while low, is within the bounds of reasonableness and should be used by us in our decision herein. As hereafter indicated, some additional adjustment is required in his computations to reflect a change in the five-year future period.

Our disposal of Midwestern's contentions simlarly dictates our action with respect to East Tennessee. East Tennessee does not seriously contest its growth status or its potential for future growth. In these circumstances our ruling in the *Alabama-Tennessee* proceeding is clearly controlling.

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[35] Docket No. CP66-172, application filed 12/2/65, additional 25,000 Mcf/d interruptible on Northern System, certificate issued 3/25/66; Docket No. CP63-149, certificate issued 7/27/64, additional 25,000 Mcf/d contract demand on Southern System; Docket No. CP66-15, certificate issued 11/29/65, additional 20,000 Mcf/d temporary winter service on Southern System. No additional facilities were added for these expansions.

[36] Midwestern's witness testified that the depreciable portion of these additions would amount to $3,887,000.

East Tennessee has had gross plant additions in each of the past ten years.[37] The company has stated that the requirements of its existing customers are increasing at an average of about 5 percent per year. In 1964 it spent $6,668,182 for construction of its Virginia extension;[38] an additional $1,397,793, including $378,818 for completion of the extension was booked in 1965.[39] During the five-year period 1961-1965, East Tennessee's average annual growth rate was 6.37 percent. For the 15-year period 1951-1965, the average growth was 4.96 percent. Recently, by Opinion No. 493,[40] East Tennessee was denied authorization to construct an estimated $4,160,000 worth of facilities intended to increase its peak day capacity by 22,141 Mcf per day. On May 17, 1966, East Tennessee filed a new application for authority to construct approximately $1,700,000 in pipeline facilities to increase its daily design capacity to 235,338 Mcf and its sales capacity by 47,224 Mcf per day. In addition to growth in gross plant, volumetric deliveries on the East Tennessee system have grown consistently. The deliveries on the East Tennessee system in 1956, the first full year of operation, were 17,371,000 Mcf. By 1965 the yearly volume had risen to 34,242,444, an average yearly increase of approximately 10 percent. Peak day sales on the system increased from 80,483 Mcf in 1956 to 166,106 Mcf in 1965, an average yearly increase of 10.6 percent.

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[37] See Examiner's decision, mimeo. p. 18.

[38] *East Tennessee Natural Gas Co.*, Opinion No. 435, 32 FPC 158.

[39] 1965 Annual Report, FPC Form No. 2. Part of the $1,397,793 is attributed in the Annual Report to "land and land rights." To the extent land is involved, it would not constitute a depreciable asset. Our inclusion of the total figure is more than offset by the general conservativeness of our computations with regard to East Tennessee as to both the anticipated future growth and the minimal adjustment effected for 1954-1963 plant additions (Appendix C).

[40] *Transcontinental Gas Pipe Line Corp., et al.*, Docket Nos. CP64-270, *et al.*, issued June 8, 1966, 35 FPC —.

In our opinion East Tennessee will experience a growth in its gross plant of not less than 4 percent per annum for the foreseeable future. While this growth rate is conservative compared to the growth history, we believe this figure may properly be used for present purposes.

Conclusion

Midwestern and East Tennessee argue that their managerial decision to revert to straight-line depreciation was a bona fide evaluation of the impact of our decision in the *Alabama-Tennessee* proceeding. They contend that their original election to use liberalized depreciation was made in reliance on the Commission's normalization policy then in effect and that the wholly changed conditions resulting from the flow-through requirements imposed by the *Alabama-Tennessee* proceeding adversely threatened the company's financial integrity. In our *Alabama-Tennessee* decision, we took full cognizance of each company's right to re-evaluate their decision to utilize liberalized depreciation in the light of our holdings. Indeed that decision was, by its terms, applicable only to the Alabama-Tennessee company. It constituted merely a "proposed decision" with respect to those other pipeline companies wherein the Commission had reserved the question of the proper treatment of liberalized depreciation in the company's allowance of Federal income taxes in the cost-of-service used for prescribing future rates. Of course, a substantial impact of the decision upon the other regulated companies subject to the Commission's jurisdiction was recognized and taken into consideration. We made clear that we would not impose a flow-through requirement in those circumstances wherein refusal to normalize tax deferrals might well compel future customers to subsidize present ones, or shift to jurisdictional customers a tax burden properly charged to non-jurisdictional customers. Both Midwestern and East Tennessee, rather than presenting evidence to this Commission defending their entitlement to

utilize liberalized depreciation with normalization rather than flow-through for ratemaking purposes, reverted to straight-line depreciation. This was the one method certain to result in a maximum Federal tax cost to themselves and maximum rates to their customers.

The primary argument by Midwestern and East Tennessee in support of their decision against the continued use of liberalized depreciation to reduce their tax liabilities is that their standing will be injured if the tax reductions available to them are taken without any protection from the possibility of an increased tax liability should their future investment outlays decline below the present levels.[41] It is to guard them against this future possibility that, they say, their present consumers should pay increased taxes, *i.e.*, higher rates.

As we have seen, there is little likelihood that either Midwestern or East Tennessee will reach a situation in the proximate future where the amount owed the Federal government under liberalized depreciation tax accounting will exceed the amount due under straight-line depreciation. Though the possibility exists, it is, at best, remote. The increased rates attributable to their decisions to drop, or not to use, liberalized depreciation, however, are not remote; they are a fact. The rates being collected today are higher than they would be under liberalized depreciation. For Midwestern and East Tennessee to argue that their present customers should be required to pay higher rates than would be required under liberalized depreciation in order that they, the companies, will be relieved of the *uncertain* burden that might develop from the unlikely occurrence that the dollar value of their gross gas plant

[41] East Tennessee has an accumulated balance of $234,000 in Account No. 282, which is being held pending disposition of the Docket No. R-264 rulemaking proceeding (See footnote 14). As observed earlier (footnote 13), Midwestern's accumulated reserve was refunded in 1964 under its settlement.

will not at least remain stable is strikingly unconvincing. The chance that the investment in utility property will decline in the years ahead, either for the industry as a whole or for Midwestern and East Tennessee alone, can be rated, realistically, as not more than a minimum contingency.

In its exceptions to the Examiner's findings regarding the facts underlying its reasons for changing to straight-line depreciation, Midwestern makes the point that it was influenced in its decision by its conclusion that liberalized depreciation with flow-through would impose a heavy financial burden on its future customers "for the reason that flow-through would borrow tax deductions from the future to lower today's rates." We find the argument lacks merit primarily for the reason that it evidences a concern for customers who will be burdened only if the most adverse possibilities are realized, rather than for the present users who, if the policy not to use liberalized depreciation is validated, are now being forced to bear the burden of management's decision—a burden which, under the law, it is not at all certain that any customer, present or future, will be called upon to bear. "The Commission must, of course, concern itself with the possibility of having misread the future. . . . But we should expect agency policy to be sufficiently flexible to attempt to change with changing times. Sufficient unto the day is the evil thereof." [42]

In our opinion, staff's estimate of a growth rate approximating 7 percent annually for Midwestern is not wholly unrealistic. However, for our purposes we have assumed a conservative growth of only 1.5 percent per year. Although Midwestern's witness recanted this estimate, we believe the prediction is reasonable. Evidence submitted by staff shows that while Midwestern may experience some few years of increased taxes over the normal plant life

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[42] *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, *supra*, 359 F. 2d at p. 339.

cycle, the net effect will be of a substantial tax reduction. Furthermore, if Midwestern or East Tennessee really felt that the companies would be harmed by flow-through, they had the option at all times of coming to the Commission, proving their impairment, and requesting permission for continued normalization. The fact that they did not do so and, instead, chose to drop liberalized depreciation, indicates an uncertainty in their ability to sustain the necessary burden of proof.

The directors of Midwestern and East Tennessee reached a decision that liberalized depreciation with flow-through as required by our Opinion No. 417 was not in the best interest of their companies. Whether sufficient consideration was given to the effects of the changeover, particularly in Midwestern's case where the decision came less than two weeks after the *Alabama-Tennessee* decision, need not concern us here. The pipelines and INGAA argue that the companies' actions do not constitute an abuse of discretion. For the reasons stated in this decision, and recognizing again the broad scope of managerial discretion which should be allowed the companies in the conduct of their affairs, we conclude that the actions of Midwestern and East Tennessee do, in fact, exceed the ambit of managerial discretion. Accordingly, appropriate rate reductions will be ordered consistent with this Opinion as reflected in the attached appendices.

The City of Chicago contends that the tax savings which Midwestern would have realized from the use of liberalized depreciation should be reflected in the company's rates effective as of the date of our Opinion No. 444 and Order, *i.e*, October 13, 1964. We agree with the Examiner that, with regard to East Tennessee, a prospective approach is proper in order to afford the company appropriate opportunity to conform, or reconform, its depreciation practice with the rate treatment here ordered and to obtain the necessary consent from the Commissioner of Internal Reve-

nue to effect the reversion. Since the Internal Revenue Service has ruled that permission cannot be granted retroactively, and, therefore, the reversion can take effect only with the start of the 1967 tax year, and since the issue in this proceeding has not previously been decided by us, we believe it is more equitable that the use of the liberalized method in the computation of East Tennessee's tax costs for ratemaking purposes should likewise be required as of January 1, 1967. Although the issue was reserved in the original rate case, the prospective application of our decision is consistent with the general nature of rate reductions ordered under Section 5(a) of the Act.

However, as the City of Chicago points out, Midwestern has voluntarily established the effective date for the results of the present proceeding in its settlement agreement resolving the various issues in Opinion No. 444. The history of the settlement negotiations illustrates that the setting of the effective date of the present proceedings was the essential *quid pro quo* demanded by Chicago and accepted by Midwestern, the Commission staff and other parties as Chicago's condition for acceptance of the terms of the settlement proposal.

The settlement itself is unusual in that it specifically amends Commission Opinion No. 444. Midwestern submitted its proposal on November 12, 1964, together with its petition for rehearing of Opinion No. 444. Basically, Midwestern proposed to accept the ratemaking principles of Opinion No. 444 in return for the dismissal of any further proceedings on the reserved issue regarding the appropriate rate treatment of liberalized depreciation. It was the subject of intensive discussions by the staff, Midwestern and Midwestern's customers. On December 14, 1964, Midwestern and staff arrived at a modified settlement agreement. The principal difference between Midwestern's original proposal and the modification was an agreement by Midwestern to flow-through all refunds and rate reductions received from TGT. Staff and all cus-

tomers with the exception of Chicago agreed. On December 19 Chicago filed a telegraphic response indicating that:

> "City of Chicago will consent to settlement proposal as modified except for the proposal to dismiss further proceedings concerning liberalized depreciation provided by ordering paragraph D of Opinion Number 444 and determination of refund to customers accruing from flow-back of accumulated deferred taxes—resolution of the issue of whether or not Midwestern may arbitrarily increase its tax expenses by refusing to take advantage of all tax deductions to which it is legally entitled is of cardinal importance to City of Chicago—A Commission determination on this issue in accordance with position of City would result in a substantial annual reduction in cost of gas to Midwestern's customers—"

Thereafter, a conference was held among representatives of the City of Chicago, Midwestern and the Commission staff, at which the terms of settlement of the proceedings were agreed to. Subparagraph (6) of the settlement agreement provides as follows:

> "(6) The question remanded to the examiner for hearing by ordering paragraph (D) of Opinion No. 444 shall proceed to hearing in accordance with the procedures to be prescribed either by the Commission or the Presiding Examiner. The adjustment, if any, to Midwestern's rates to reflect the Commission's final disposition of this issue, as referred to in said paragraph (D), *shall be effective as of October 13, 1964.* All parties reserve whatever rights they may have to seek review of any final Commission order on this issue." (32 FPC 1549, emphasis added)

Significantly, paragraph (8) of the settlement agreement expressly declares the intent of the terms of the agreement to modify Opinion No. 444: "Except as modified in the

above seven paragraphs, Opinion No. 444 remains final and binding."

On its face there can be little dispute but that the settlement agreement approved by the Commission expressly modified the provisions of Opinion No. 444 which had provided that the resolution of the liberalized depreciation issue should have prospective effect only. It is interesting to note that Midwestern's counsel originally so interpreted it.

In the course of the hearings in the present proceeding, staff and the City of Chicago, on July 13, 1965, moved to postpone the hearings on the deferred issue until an appropriate date subsequent to final affirmance of the Commission's Opinion No. 417 in the *Alabama-Tennessee* proceeding. At pages 24 and 25 of the record certified to the Commission by the Examiner relating to staff and the City's motion, Counsel for Midwestern advised the Examiner as follows:

> "As was mentioned earlier under the provisions of the Commission's order of December 3 [sic—30], 1964, in this proceeding, the adjustments, if any, in Midwestern's rates to reflect the Commission's final disposition of the reserved issue in this hearing shall become effective as of October 13, 1964, which is, of course, last October. So that we are talking about a retroactive rate effect, if any is to be given on this issue, and not one that would be prospective only."

In view of the expressed terms of the settlement agreement, which agreement was expressly accepted and approved by this Commission, we conclude that, absent a finding that the agreement is contrary to the public interest and unjust and unreasonable under the Natural Gas Act, that the Commission has no discretion but to require Midwestern to recompute its rates from October 13, 1964.[43]

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[43] *Texas Eastern* v. *Federal Power Commission*, 360 F. 2d 345.

Accordingly, Midwestern, within 60 days from the issuance of this Opinion and Order, shall file with the Commission a report reflecting the savings attributable to the use of liberalized depreciation in conformity with our findings herein. Specifically, the cost-of-service approved in Opinion No. 444, as modified and amended, shall be adjusted to reflect the benefits attributable to liberalized depreciation on an averaged basis of the benefits resulting from its actual gross plant additions for 1964, 1965 and 1966, and an assumed 1.5 percent annual gross plant growth for the years 1967 and 1968. The resulting differences shall be held in escrow by Midwestern pending further order of this Commission as to its equitable distribution.

The Commission further finds:

(1) Midwestern and East Tennessee are each a natural-gas company subject to the provisions of the Natural Gas Act, and the sales of natural gas for resale which are the subject of this Opinion and Order are sales of natural gas in interstate commerce and are subject to the jurisdiction of this Commission.

(2) The use of liberalized depreciation, under Section 167 of the Internal Revenue Code, results in a permanent reduction of taxes payable to the Treasury Department by natural-gas pipelines which maintain either a growing or stable plant.

(3) In enacting the Internal Revenue Act of 1954, as amended, Congress did not attempt to prescribe the manner in which this Commission should reflect such tax benefits in rates established under the Natural Gas Act.

(4) Rate flow-through of the tax savings occasioned by the use of liberalized depreciation will effectively and substantially promote expanded plant investment by regulated companies, including Midwestern and East Tennessee, and will best implement the fundamental objective of Sec-

tion 167 of the Internal Revenue Code, to benefit the national economy by stimulating plant modernization and expansion.

(5) There is no present factual justification for basing the Federal income tax allowances for natural gas companies which maintain either a growing or stable plant on straight-line depreciation tax deductions when liberalized depreciation tax savings are available to such companies, without any genuine detriment or material risk.

(6) Midwestern will maintain a growing plant for the foreseeable future in an amount approximately equal to that projected in Appendix A.

(7) The proper tax depreciation deduction to be used in determining Midwestern's just and reasonable rates in Docket Nos. RP61-19 and RP62-7 (reopened) is $3,864,510.

(8) Midwestern should be required to file substitute tariff sheets, subject to the approval of the Commission, reflecting a reduction in its cost-of-service of $546,960 and containing the rates herein found to be just and reasonable as set forth in Appendix B; such rates to be effective beginning January 1, 1967, and to continue in effect until changed by further order of the Commission. Pursuant to its express settlement obligation Midwestern should also be required to make refunds reflecting the appropriate liberalized depreciation tax deductions for the period from October 13, 1964 to January 1, 1967.

(9) Except as otherwise decided in this Opinion, the rates set out in Appendix B should continue to be subject to all the applicable terms and conditions contained in Opinion Nos. 444 and 477, and the Order Approving Proposed Settlement issued December 30, 1964.

(10) East Tennessee will maintain a growing plant for the foreseeable future in an amount approximately equal to that projected in Appendix C.

(11) East Tennessee should be required to file substitute tariff sheets, subject to the approval of the Commission, reflecting a reduction in its cost-of-service of $264,185 and containing the rates herein found to be just and reasonable as set forth in Appendix D; such rates to be effective beginning January 1, 1967, and to continue in effect until changed by further order of the Commission.

(12) Except as otherwise decided in this Opinion, the rates set out in Appendix D should continue to be subject to all the applicable terms and conditions contained in Opinion No. 488.

(13) The exceptions to the Examiners' decisions, except as granted herein, should be denied.

(14) The Examiners' decisions, to the extent consistent herewith, should be adopted as part of this Opinion and Order.

The Commission orders:

(A) Within 45 days from the date of issuance of this Opinion and Order, Midwestern and East Tennessee shall file substitute tariff sheets, effective as of January 1, 1967, and satisfactory to the Commission, containing the rates herein found to be just and reasonable as set forth in Appendices B and D, respectively, attached hereto.

(B) Midwestern shall, within 60 days from the date of issuance of this Opinion and Order, file a report showing the refunds due its jurisdictional customers which are attributable to liberalized depreciation tax savings during the period from October 13, 1964 to January 1, 1967. Copies of the report shall be sent by Midwestern to all its jurisdictional customers. Midwestern shall take no action to effectuate making the refunds pending the further order of the Commission.

(C) Except as herein granted, the exceptions to the Examiners' decisions are hereby denied.

(D) The Examiners' decisions, to the extent consistent herewith, are hereby adopted as part of this Opinion and Order.

By the Commission. Commissioners O'Connor and Bagge dissenting filed separate statements appended hereto.

(SEAL)

JOSEPH H. GUTRIDE
Secretary

Docket Nos. RP61-19 and RP62-7 (reopened)

APPENDIX A
Sheet 1 of 2

MIDWESTERN GAS TRANSMISSION COMPANY
REDUCTION IN REVENUE REQUIREMENTS FOR THE PERIOD 1967-71 DUE TO LIBERALIZED DEPRECIATION DEDUCTIONS FOR TAX PURPOSES (DOUBLE DECLINING METHOD) USING 3.5 PERCENT RATE ON STRAIGHT-LINE METHOD

Depreciable Property Additions Year	Amount	1967	1968	1969	1970	1971
1965	$ 325,979	$ 20,471	$ 19,037	$ 17,701	$ 16,462	$ 15,321
1966	4,379,645 [1]	296,064	275,042	255,771	237,815	221,172
1967	1,393,319	48,766	94,188	87,500	81,370	75,657
1968	1,414,219		49,498	95,601	88,813	82,590
1969	1,435,432			50,240	97,035	90,145
1970	1,456,963				50,994	98,491
1971	1,478,817					51,759
Liberalized Depreciation Tax Deduction		$365,301	$437,765	$506,813	$572,489	$635,135
Straight Line Tax Depreciation		189,080	238,212	288,081	338,698	390,073
Excess Liberalized over Straight Line		$176,221	$199,553	$218,732	$233,791	$245,062
Adjustment for 1959-64 additions		882,477	611,883	360,232	126,196	(91,459)
Adjusted excess Liberalized over Straight Line		$1,058,698	$811,436	$578,964	$359,987	$153,603
Reduction in Revenue Requirements Related to Excess Liberalized Depreciation		$977,263	$749,020	$534,430	$332,297	$141,788

Year	Excess Liberalized	Reduction in Revenue Requirements
1967	$1,058,698	$ 977,263
1968	811,436	749,020
1969	578,964	534,430
1970	359,987	332,297
1971	153,603	141,788
Five year totals	$2,962,688	$2,734,798
Annual Average	$ 592,538	$ 546,960

[1] In addition to the $3,887,000 depreciable portion of the storage field project, we have included an amount of $492,645 which is the annual average of Midwestern's plant additions during the years 1961-1965.

Docket Nos. RP61-19 and RP62-7 (reopened)

APPENDIX A
Sheet 2 of 2

MIDWESTERN GAS TRANSMISSION COMPANY

UNIT RATE REDUCTION DUE TO LIBERALIZED DEPRECIATION TAX DEDUCTIONS

Net Plant per Settlement Cost of Service (C/S)

Northern System	$42,667,396	50.6736%
Southern System	$41,533,059	49.3264%
Total	$84,200,455	100.0000%

Reduction to

Northern System C/S $546,960 × 50.6736%=	$277,164
Southern System C/S $546,960 × 49.3264%=	$269,796
Total	$546,960

	Total Company	Northern System	Southern System
Settlement C/S	$66,985,223	$24,401,313	$42,583,910
Average Annual Reduction in Revenue Requirements (1967-1971)	546,960	277,164	269,796
Adjusted C/S	$66,438,263	$24,124,149	$42,314,114

Determination of Rate Reduction

	Total	Demand	Commodity
Northern System	$277,164	$ 138,582	$ 138,582
Billing Determinants		2,339,782	60,527,841
Unit Rate Reduction		$0.06	.23¢
Southern System	$269,796	$ 269,796	—
Billing Determinants		4,800,000	—
Unit Rate Reduction		$0.06	

Docket Nos. RP61-19 and RP62-7 (reopened) APPENDIX B

MIDWESTERN GAS TRANSMISSION COMPANY

RATES EFFECTIVE 1-1-67 AND REVENUES RESULTING THEREFROM

Rate Schedules	Billing Determinants		Rates		Revenues
	Demand	Commodity	Demand	Commodity	
Northern System					
SR-2	20,364	247,767	—	56.58¢[1]	$ 140,187
CR-2	51,058	750,470	$3.88	24.69¢	383,396
CD-2	1,896,000	53,443,500	3.88	24.69¢	20,551,680
I-2	—	290,856	—	24.69¢	71,812
CRL-2	372,360	5,795,248	4.13	24.69¢	2,968,694
Total Northern System	2,339,782	60,527,841			$24,115,769
Southern System					
CDX-1	3,600,000	95,569,500	2.97	22.0¢	$31,717,290
CD-1	1,200,000	31,983,000	2.97	22.0¢	10,600,260
SR-1	—	—	—	46.41[2]	—
SI-1	—	—	—	26.88[3]	—
Total Southern System	4,800,000	127,552,500			$42,317,550
				TOTAL	$66,433,319

[1] Reflects CD-2 rate level at 40% load factor.
[2] Reflects CD-1 rate level at 40% load factor.
[3] Reflects CD-1 rate level at 200% load factor.

RP65-4

APPENDIX C
Sheet 1 of 2

EAST TENNESSEE NATURAL GAS COMPANY

ANNUAL REDUCTION IN REVENUE REQUIREMENTS FOR TAX PERIOD 1967-71
DUE TO LIBERALIZED DEPRECIATION DEDUCTION FOR TAX PURPOSES
(DOUBLE DECLINING METHOD) USING 3.5 PERCENT RATE ON
STRAIGHT-LINE METHOD

Property Additions		Liberalized Depreciation Deductions				
Year	Amount	1967	1968	1969	1970	1971
1965*	$6,668,182	$403,712	$375,452	$349,170	$324,728	$301,997
	1,397,793	87,781	81,631	75,900	70,589	65,696
1966	1,623,130	109,724	101,933	94,791	88,136	81,968
1967	1,688,055	59,082	114,113	106,010	98,582	91,661
1968	1,755,578		61,445	118,677	110,250	102,526
1969	1,825,801			63,903	123,424	114,660
1970	1,898,833				66,459	128,361
1971	1,974,786					69,118
Liberalized Depreciation Deduction		$660,299	$734,574	$808,451	$882,168	$955,987
Straight Line Depreciation		368,660	428,924	491,598	556,779	624,567
Excess Liberalized over Straight Line		$291,639	$305,650	$316,853	$325,389	$331,420
Adjustments for 1954-63 additions		105,026	97,668	90,811	84,456	78,603
Adjusted Excess Liberalized over Straight Line		$396,665	$403,318	$407,664	$409,845	$410,023
Reduction in Revenue Requirements Related to Excess Liberalized Depreciation (92.308)		$366,154	$372,295	$376,306	$378,320	$378,484

* Additions of $6,668,182 were placed in service during October-December 1964. For purposes of this computation these additions are assumed to be 100% available for liberalized depreciation at January 1, 1965.

Summary

Year	Excess Liberalized over Straight Line Depreciation	Reduction in Revenue Requirements
1967	$ 396,665	$ 366,154
1968	403,318	372,295
1969	407,664	376,306
1970	409,845	378,320
1971	410,023	378,484
Five year totals	$2,027,515	$1,871,559
Annual Average	$405,503	$374,312

Docket No. RP65-4

APPENDIX C
Sheet 2 of 2

EAST TENNESSEE NATURAL GAS COMPANY

UNIT RATE REDUCTIONS DUE TO
LIBERALIZED DEPRECIATION DEDUCTIONS

	Total	Demand	Commodity
Average Annual Reduction in Revenue Requirements (1967-1971)	$374,312	$187,156	$187,156
Jurisdictional Portion (Opinion No. 488, App. B)		78.618%	62.540%
Jurisdictional Reduction	$264,185	$147,138	$117,047
Unit Rate Reduction			

$264,185 ÷ 37,174,882 = 0.7107¢

Reduction by Rate Schedules
(Commodity Component)

G-1 & CR-1	1.42¢
G-2 & CR-2	1.42¢
CR-3 & CPR-3	1.42¢
G-1 Development	—
SG-1	0.71¢
SG-2	0.71¢
I-1	—
I-2	—

Docket No. RP65-4

APPENDIX D

EAST TENNESSEE NATURAL GAS COMPANY
RATES EFFECTIVE 1-1-67 AND REVENUES RESULTING THEREFROM

	Billing Determinants		Rates		
Rate Schedule	Demand	Commodity	Demand	Commodity	Revenues
G-1 & CR-1	576,313	10,759,216	$3.25	24.32¢	$ 4,489,658
G-2 & CR-2	—	—	$3.50	26.82¢	—
CR-3 & CPR-3	228,612	3,850,558	$3.75	29.32¢	1,986,279
G-1 Development	—	98,556	—	80.0¢	78,845
SG-1	—	5,643,466	—	49.22¢	2,777,714
SG-2	—	2,311,868	—	53.42¢	1,235,000
I-1	—	9,740,790	—	No Change	3,054,577
I-2	—	2,233,145	—	No Change	770,208
Total	804,925	34,637,599			$14,392,281

Docket No.
RP 61-19 *et al.*

MIDWESTERN GAS TRANSMISSION COMPANY *et al.*

(Issued July 15, 1966)

O'CONNOR, Commissioner, *dissenting:*

While joining in Commissioner Bagge's dissent, I also wish to reemphasize the views expressed in my dissent in *Alabama-Tennessee*[1] and add these comments.

The majority states candidly that it does not want to reargue the merits of *Alabama-Tennessee* in the present proceeding. Their position is readily understandable. However, the present case must be considered in context as the second in a line of unjudicious decisions, of which *Alabama-Tennessee* is the first.

In *Alabama-Tennessee* the majority made mandatory the flow-through of benefits as a result of liberalized depreciation and thereby reversed the commission's past policy. Prior to that decision companies were encouraged to voluntarily choose liberalized depreciation for tax purposes and the benefits were shared by the ratepayers, and, to a lesser extent by the stockholders.[2] It is important to note, however, that under our Uniform System of Accounts the differences in tax accumulations between liberalized depreciation and straight-line depreciation were fully recorded in the accounts under our control so that the financial integrity of the company would be maintained and companies were precluded from making any distributions of dividends from these reserves.

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[1] *Alabama-Tennessee Natural Gas Company,* Opinion No. 417, issued February 3, 1964, 31 FPC 208; rehearing granted for further consideration 31 FPC 768; rehearing and stay denied, Opinion 417-A, 31 FPC 928.

[2] *Panhandle Eastern Pipe Line Company,* Opinion No. 269, affirmed in *City of Detroit* v. *F.P.C.*, 230 F. 2d, 810 (CADC 1955).

Thus, as is the situation in the instant case, where a company's management finds the continued use of liberalized depreciation under the revised rules prescribed by the Commission in *Alabama-Tennessee* inimical to the company's financial integrity and endeavors to revert to straight-line depreciation, the majority will now preclude the exercise of what heretofore has been a managerial right. The next case which will inevitably follow as the third in this line of decisions will be a reconsideration of whether a company utilizing straight-line depreciation can be forced to institute liberalized depreciation. Heretofore, the Commission has answered this question in the negative[3] but I submit that the impetus of today's decision in combination with *Alabama-Tennessee* will lead to reconsideration and a resultant affirmative answer, thereby forcing liberalized depreciation on companies which have heretofore remained on straight-line. To prevent this and other inequities, it is imperative that *Alabama-Tennessee, Midwestern* and *East Tennessee* be reviewed in context of the unjudicious positions they represent and reversed.

It is anomalous that the majority not only denies management the privilege of tax deferral but bars it the alternative of non-use of liberalized depreciation. This denial is inconsistent with the views of another Government agency also having broad jurisdiction over accounting matters, namely, the Securities and Exchange Commission which, except where regulatory directive is present, would require tax deferral accounting for the tax effects of liberalized depreciation. Furthermore, the American Institute of Certified Public Accountants (AICPA), responsible for ethical and professional standards in the accounting profession, has opposed the accounting for the tax effects of liberalized depreciation which the majority is presently forcing on utilities as not being in accordance with good

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[3] *United Gas Pipe Line Company*, Opinion No. 428. *Wisconsin Michigan Power Company*, Opinion No. 432.

accounting practice and permitted only where prescribed by regulatory commissions.[4].

A possible disadvantage of mandatory liberalized depreciation could be the forced distribution of what are frequently referred to as "tax free" dividends. By forcing a company to use liberalized depreciation for tax purposes, and allowing it to continue with straight-line depreciation for book purposes, differences between the two will necessarily result. Since book earnings are usually larger than tax earnings and since corporate dividends are ordinarily paid from book corporate surplus, dividends may exceed the accumulated undistributed earnings for income tax purposes. Consequently, dividends from corporate surplus may be in excess of the "tax surplus." Thus, for tax purposes, such dividends would not be a distribution of earnings but a return of capital, hence not subject to tax. To be sure, the effect would be greater on a young company than on one with a large accumulated surplus, and granted if projected over a long period of time, say 15 to 30 years, a leveling effect will take place to the extent pay back increases toward the end of the depreciation life of the property, but this will not affect the large investor who is not so interested in dividends as in capital gains which will have already accrued.

Furthermore, whether the reserves presently accumulated because of the difference between liberalized depreciation for tax purposes and straight-line depreciation for book purposes will ever be used for the purposes envisioned by the majority, may depend upon whether Congress elects to change the tax laws or tax rates in the future. The majority fails to take this into consideration.

When all elements of this problem are put properly into focus, it is evident that the surest way to prevent dis-

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[4] Accounting Research Bulletin No. 44 (Revised July 7, 1958, Committee on Accounting Procedure, AICPA. Also Accounting Service Release No. 85, SEC, F. 29, 1960).

crimination among various ratepayers, present and future, and to ensure the continuing financial integrity of all elements in the industry where a company chooses, or is forced by the regulatory authorities, to utilize liberalized depreciation for tax purposes is to follow the present procedures directed by our Uniform System of Accounts and provide for normalization of the tax expense over the lives of the property involved and the accumulation of the difference between taxes paid and taxes accrued in a deferred tax reserve upon which no rate of return would be allowed.[5] Such a procedure would be eminently more flexible than flow-through since the stockholders would not receive any extra gains and the ratepayers would pay according to the rates prescribed by the Code as being commensurate with services rendered.[6] Thus, the ratepayer would pay for what he received, not for what his forebearers received or his heirs might receive. Furthermore, it is quite likely that the improved financial integrity of the company under this procedure could lead to reduced rates for future capital requirements and, therefore, bring about lower utility rates to all ratepayers.

LAWRENCE J. O'CONNOR, JR.

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[5] In *Alabama-Tennessee* I endorsed a 1½% return on deferred tax reserves based upon the *Panhandle* philosophy (*Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 316 F. 2d 659 [D.C. Cir. 1963]) of encouraging companies to use liberalized depreciation. However, in view of subsequent events, I am now convinced that no rate of return should be allowed on these reserves.

[6] Likewise such a procedure would not result in the inequities that have fallen the lot of Midwestern by forcing them to flow through the "benefits" of liberalized depreciation retroactively without recourse, and the administrative problem, which is now the Commission's, of having to determine when flow-through should be effective would be obviated.

MIDWESTERN GAS TRANSMISSION COMPANY KNOXVILLE UTILITIES BOARD, *et al.* EAST TENNESSEE NATURAL GAS COMPANY	Docket Nos. RP61-19, RP62-7 (Reopened) RP65-4

(Issued July 15, 1966)

BAGGE, Commissioner, *dissenting:*

This decision is wrong. It is bad law. It is far worse policy. It is a dangerous precedent. Specifically, it is wrong for each of the following reasons:

(1) The decision is totally inconsistent with other decisions of this Commission following *Alabama-Tennessee*;[1]

(2) The decision violates a basic principle of public utility law governing the scope of managerial discretion;

(3) The decision contravenes national economic policy as it is reflected in tax policy;

(4) The decision does violence to fundamental concepts of fairness and equity;

(5) The decision contravenes existing regulatory policy of virtually all of the states which have dealt with the issue; and, finally,

(6) In addition to all of the foregoing considerations, when viewed simply as a matter of regulatory policy, the decision contravenes the public interest.

This decision strikes at the very heart of the regulatory confrontation with management expertise. In effectively and decisively carving out of the scope of managerial dis-

[1] *Alabama-Tennessee Natural Gas Company*, Opinion No. 417, issued February 3, 1964, 31 FPC 208; rehearing granted for further consideration 31 FPC 768; rehearing and stay denied, Opinion No. 417-A, 31 FPC 928.

cretion this vital function of management, the majority in essence holds that a management which has the temerity to disagree with the Commission on the practical application of an abstract principle of corporate finance is to be adjudged guilty of an abuse of management discretion. This decision increases the scope of the uncertainties already existing in the natural gas industry. It concerns not only Midwestern and East Tennessee, but is of profound significance to the entire natural gas and electric power industries subject to the jurisdiction of this Commission. Indeed, its impact will be felt, albeit indirectly, by all of the Nation's utilities.

The Nation requires strong utilities. This is a legitimate objective of regulation. Regulatory policy should, as a consequence, be directed toward the achivement of this goal. The methodology employed in depreciating the Nation's vast utility assets is so vital to the financial integrity of its utilities and is so inherently a part of management expertise that I cannot, on the basis of speculation as to what the future holds, preempt this function.

My colleagues have stated, and I agree, that " it is not our purpose to re-argue the merits of *Alabama-Tennessee* for, in this proceeding, we consider, for the first time, an issue which was reserved in *Alabama-Tennessee* and which the Court of Appeals for the Fifth Circuit did not decide.[2]

In *Alabama-Tennessee*, the Commission stated:

> "We do not have before us the question whether a utility which has not exercised its option to claim the tax benefits of liberalized depreciation should have its rates fixed on the basis of the availability of such higher depreciation deductions, and nothing in this

[2] *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, No. 21610, 359 F. 2d 318, (CA 5) Petition for Cert. filed June 23, 1966 No. 286, Oct. term 1966.

opinion should be taken as an indication of our views on that question." (31 FPC at p. 210).

On appeal, the Fifth Circuit stated:

"Since the Commission has not yet ruled on Petitioner's (Alabama-Tennessee) application for conversion to straight-line tax depreciation, the effect of the proposed conversion is not a proper subject for review in this case." (Slip Op. p. 38).

In this Section 5(a) proceeding, the majority, having experienced the "industry-regulator impasse" called to the Commission's attention by Commissioner O'Connor in his dissent in *Alabama-Tennessee*,[2] orders Midwestern and East Tennessee to use liberalized depreciation for regulatory purposes although the companies have elected to exercise their statutory option to change to straight-line depreciation in the compilation of their Federal income tax. The majority is really finding that, to be effective, both liberalized depreciation and flow-through must be mandatory. Significantly, although the majority does not decide ". . . at least directly, how Midwestern and East Tennessee shall pay their income taxes . . ." leaving ". . . the companies free to choose their own method for filing their tax returns," the freedom is illusory because this decision effectively negates the element of management choice which has been expressly provided by the Congress.

Section 167 of the Internal Revenue Code provides that taxpayers have the statutory option to elect to use or not to use the liberalized depreciation provision for the purpose of computing Federal income taxes. The election determines a cost component in the cost of service, and the cost of service serves to determine the rate to be charged. Section 167(e)(1) of the Internal Revenue Code permits a taxpayer to change at any time from liberalized deprecia-

[2] At page 237.

tion to the straight-line method. The converse is not true; once the taxpayer elects to go from liberalized to straight-line, government consent is necessary before the taxpayer may revert. Since the Internal Revenue Code grants management this option, I conclude that management has both the prerogative and the correlative responsibility of exercising that option in the best interests of the business and its customers.

Such a decision cannot lawfully be overturned by a regulatory agency absent an abuse of management discretion. The election to adopt liberalized or straight-line depreciation involves risks and uncertainties which are best known to those with an intimate knowledge of a particular company. These are individual management decisions to be made on the basis of the circumstances of each individual case. I cannot, on the basis of mere disagreement, hand to consumers a short range benefit[4] at the expense of creating great uncertainty within the regulated industries. This is especially true in light of the fact that this will be still another regulatory about-face similar to the one for which the Commission was so severely chastised by the Fifth Circuit in *Alabama-Tennessee.*

Subsequent to *Alabama-Tennessee,* the setting of rates based on hypothetical liberalized depreciation was expressly rejected by this Commission in *United Gas Pipeline Company,*[5] and *Wisconsin-Michigan Power Company.*[6] In *Wisconsin-Michigan,* the Commission found that its acceptance of the company's use of straight-line depreciation was not

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[4] It is undisputed that the benefits of flow-through are only going to the consumer for a short period, usually from seven to twelve years. After that, consumers will get no net return benefit from flow-through.

[5] *United Gas Pipe Line Co.,* Opinion No. 428, 31 FPC 1180 (1964).

[6] *Wisconsin-Michigan Power Co.,* Opinion No. 432, 31 FPC 1445 (1964).

inconsistent with the obligations of a regulated company to operate with all reasonable economies. There the Commission stated:

> "We have heretofore taken the position that, if a utility chooses to utilize a liberalized depreciation option permitted by the tax laws, the benefits thereof must be flowed through to ratepayers within the operating year. Intervenors would have us go one step further and set the rates of a regulated utility as if it voluntarily used liberalized depreciation (as well as guideline service lives), even though the utility in fact chose to employ straight-line depreciation, as *Wis-Mich* has done. Intervenors' position proceeds from the proposition that public utilities are obligated to operate with all reasonable economies, including the lowest reasonable tax burden, and to pass these economies along to the ratepayer.
>
> "While there can be no dispute with the principle that utilities should operate with maximum efficiency, we do not believe this rule leads to the conclusion urged by the intervenors. On this record it is clear that this company has never used liberalized depreciation and has chosen to apply straight-line depreciation to its property as a matter of business judgment. Its officers firmly believe this to be the wisest course in the long-range interests of the company and its customers. The case that has been made for requiring the company to use (or for assuming it has used) guideline service lives is not persuasive, either on the facts of this case or as a general principle, and we could not accept the intervenors' position in this regard. As to liberalized depreciation, the tax laws give management the option not to take liberalized depreciation and we do not believe that on this record we should in effect deprive the company of its option under the tax law."

In so holding, the Commission made it abundantly clear that the election to use, or not to use, liberalized depreciation is a matter of business judgment to be left to the discretion of management in each individual case. There is no rational justification either in logic or in law for establishing different criteria to a management decision to discontinue its use.

Midwestern and East Tennessee had originally elected to use liberalized depreciation in reliance on the Commission's normalization policy. When that policy was reversed in *Alabama-Tennessee*, the companies' managements elected to use straight-line depreciation. In each case management concluded that the continued use of liberalized depreciation under the wholly changed conditions would be unsound financial and business policy because of the substantial adverse impact on the company's financial integrity. Viewing the change in policy enunciated in *Alabama-Tennessee* in connection with the policy set forth in *United* and *Wisconsin-Michigan* precludes a finding that Midwestern and East Tennessee abused their discretion in reverting to a straight-line method of tax depreciation for elemental fairness requires that the companies be entitled to re-evaluate their tax depreciation methods in the light of changes in regulatory policy.

Significantly, in the Midwestern case there is no issue regarding the treatment of the accumulated reserve for deferred taxes. In its December, 1964 rate order,[7] the Commission approved an actual tax treatment of liberalized depreciation and directed Midwestern to refund to its customers the accumulated reserve for deferred taxes of $3,569,600. This action precluded the application of these deferrals to offset higher future taxes for which the deferrals had been earmarked. This action was an open invitation for Midwestern to adopt straight-line depreciation

[7] 32 FPC 1548.

tion for the remaining undepreciated tax base. Under these circumstances, Midwestern's adoption of straight-line depreciation could be viewed as a logical managerial response to protect the best interests of the company and its customers. The question of whether liberalized depreciation is suitable or necessary for all utilities has never been conclusively answered. Congress, however, gave the option to the taxpayer (management) to choose the method best suited to his particular circumstances.

The various state courts and virutally all of the state commissions who have considered this issue have concluded that the decision to use, or not to use, liberalized depreciation for tax purposes lies securely within the discretion of management. For example, the California and New York Commissions, who have adopted flow-through, have not attempted to compel any utility to take liberalized depreciation against the better judgment of its management.

Re: Tax Treatment of Accelerated Depreciation, 33 P.U.R. 3rd 209, 215 (Cal. P.U.C. 1960):

> "As a general proposition, it is a matter to be determined in the first instance by the management of a public utility as to whether or not liberalized depreciation will be availed of or whether straight-line depreciation will be used."

Re: *Niagara Mohawk Power Corp.*, 28 P.U.R. 3rd 171, 194 (N.Y. P.S.C. 1959)

> ". . . We think that the selection of the method of depreciation for tax reporting purposes is peculiarly a managerial determination . . . ."

In the following cases, utilities which had been employing accelerated depreciation reverted to straight-line depreciation after state commissions adopted the flow-through method. In each of these cases, the higher straight-line taxes were allowed in subsequent rate cases on the ground

that the election was a matter of managerial discretion: *City of Pittsburgh* v. *Pennsylvania Pub. Util. Comm'n.*, 144 A. 2d 648, 25 P.U.R. 3d 273 (1958); Re: *Southern Cal. Water Co.*, 57 Cal. P.U.C. 677 (1960); Re: *Southern Cal. Gas Co.*, 35 P.U.R. 3d 300 (1960): Re: *Southern Counties Gas Co.*, 58 Cal. P.U.C. 27 (1960); Re: *San Diego Gas & Elec. Co.*, 39 P.U.R. 3d 417 (1961); Re: *Pacific Lighting Gas Supply Co.*, 59 Cal. P.U.C. 610 (1962); Re: *Housatonic Pub. Ser. Co.*, 22 P.U.R. 3d 1 (1958); Re: *Raytown Water Co.*, 22 P.U.R. 3d 556 (1958); Re: *Piedmont Natural Gas Co.*, 34 P.U.R. 3d 1 (1960); *Pennsylvania Pub. Serv. Comm'n.* v. *Pennsylvania Power Co.*, 33 P.U.R. 3d 177 (1960); Re: *Cumberland & Allegheny Gas Co.*, 28 P.U.R. 3d 93 (1959).

In the following cases management's right to elect not to adopt accelerated depreciation was sustained against attacks by advocates of mandatory flow-through: Re: *New England Tel. & Tel. Co.*, 23 P.U.R. 3d 510 (1958); Re: *The Mountain States Tel. & Tel. Co.*, 31 P.U.R. 3d 417 (1960); Re: *New England Tel. & Tel. Co.*, 21 P.U.R. 3d 195 (1957); *Pennsylvania Pub. Util. Comm'n.* v. *Pennsylvania Gas Co.*, CCH Util. L. Rep.—State para. 17,554 (1957); *Pennsylvania Pub. Util. Comm'n.* v. *Peoples Natural Gas Co.*, 31 P.U.R. 3d 283 (1959).

All of these decisions are consistent with the general rule of utility law enjoining commission interference with managerial discretion as stated in *State of Missouri, ex rel. Southern Bell Tel. Co.* v. *Public Service Commission of Missouri*, 262 U.S. 276, 289 (1923):

> ". . . It must never be forgotten that while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *State Public Utilities Commission, ex rel. Springfield* v.

Springfield Gas and Electric Company, 291 Ill. 209, 234. 'The Commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers.' "

The majority, relying on *Acker* v. *United States*, 298 U.S. 426 (1935) state:

"An elementary proposition of utility law and utility regulation universally recognized, is that public utilities, in the interest of their customers as well as in their own interest, should be permitted to charge rates which are compensatory of the full cost incurred by alert, efficient, and responsible management. It is equally elementary that customers should not be required to pay more than this cost."

While no one can disagree with this, I do not see how such a statement can preclude the position I am taking here. Furthermore, the majority's reliance on *Acker* is misplaced. The problem to which the Court's attention is directed in *Acker* relates to the reasonableness of business expenditures. It does not relate to taxes computed in accordance with unqualified rights provided by the Congress. Therefore, *Southwestern Bell* is still the law of the land and must be followed by this Commission.

Although I have disavowed any intention to re-argue the merits of *Alabama-Tennessee*, I am compelled to point out another unwarranted hypothesis of the majority which is arguably within the ambit of that case. If the majority theory is to be validated, it must be assumed, for the purposes of this case, that the companies will have a significantly rising and continuous growth in their property accounts. The concept here of stabilization or continued growth requires projections for 60 years or more by an

absolute prediction of a 30 year life and 100% replacement for existing facilities. These projections are in conflict with the companies' projections of the limited growth associated with the specific areas served. For a pipeline system, dependent on continuous availability of low cost natural gas, projection of such low cost gas supply beyond thirty years is extremely tenuous. This elementary fact is reflected in the realities of the financial market. Debt capital is generally available in this industry for terms not exceeding 20 years. While there are no doubt many factors which combine to dictate this 20-year limitation, certainly one important factor is that the interstate transmission segment of the natural gas industry is based upon a wasting asset. Another factor is that this is an area in which conditions could be drastically changed due to technological advances either within the gas industry or within competing forms of energy.

There are a number of factors which could affect the rate of future property additions. Among these are the degree of saturation of the gas market, economic conditions of the area served, available gas reserves, technological changes, the availability of competitive sources of energy, increases or decreases in the price level, changes in the structure of the energy market, and opportunities to expand into new and undeveloped markets. The question here is whether this Commission has a sufficient basis to make the assumptions which have been used by the majority to justify mandatory flow-through of liberalized depreciation. I am forced to conclude that the conjecture of continuous growth in the property accounts of the companies involved for the period of time involved is so speculative that it does not provide a rational basis for the regulatory policy advanced herein.

In an effort to justify their opinion, the majority seizes upon the alleged competitive advantages accruing from mandatory flow-through. As I see it, there are none. In the first place, if all utilities were subject to mandatory

flow-through, there would be no competitive advantage to any one of them with respect to the others. In the second place, the argument assumes that utility rates are not otherwise affected by competitive forces. This is contrary to fact. Competitive forces do operate in the utility field. Natural gas competes with electricity, coal and oil. Gas and electric companies are competing as they never have before for markets, including industrial processing, air conditioning, and space heating. Coal has already displaced sales of interruptible boiler fuel gas in some areas. Competition exists within the natural gas industry between interstate pipeline companies in most of the major metropolitan areas of the Nation. These forces, and not mandatory flow-through are serving to promote and will continue to promote competition within the industries which we regulate.

The majority assumes that if they have guessed wrong by ordering mandatory flow-through, a remedy will always exist in the form of future rate increases. But it is the existence of these very competitive forces operative within the energy market, which the majority refuses to acknowledge exist, which may well frustrate the effectuation of such a remedy. Hence, it is the grossest error to assume that if regulation permits increased rates to provide for additional Federal income taxes in future years that such increased charges will unquestionably be collected from the consumers. It is one thing to authorize a rate calculated to recover costs. It is another thing to guarantee that the revenues will be forthcoming. It simply cannot be assumed that, irrespective of the state of the economy or of technology, rates can always be raised to produce additional revenues at any time in the future when such revenues are needed. Regulation in this regard is impotent. Only the impersonal forces of the market will determine whether a higher rate will generate additional revenue.

The history of public utility regulation is replete with examples of why the majority's theory is both unrealistic

and impractical. It is precisely at the point when a company's growth pattern differs from that of its industry, or competing industries, that the forces of competition will not permit an upward rate adjustment even though it may be permissible under regulation. In our own generation we have witnessed two private utility industries virtually eliminated and many of the companies therein forced into bankruptcy, namely, the inter-urban transit industry and the urban transit industry. Witness the recent plight of the railroad industry, where the existence of competing modes of transportation has often meant that rate increases merely resulted in further loss of tonnage and revenue. Only a few decades ago, the prospects of the manufactured gas industry were bleak. It was saved only by the introduction of low-priced natural gas. In each case the obsolescence factor which caught up with the industry, and which had not been recognized in the then current depreciation practices, produced such financial degradation to many companies that they were no longer in a position to attract the capital necessary to maintain their competitive position in the changing technology of the times. Surely, these recent experiences must have some significance to the formulation of regulatory policy.

The interstate natural gas transmission industry is devoted entirely to the transmission of a depletable resource from production areas to consuming areas. The calculations of future requirements upon which the majority's decision is based cover requirements which may well be met by imported natural gas, imported liquified natural gas, gas manufactured from coal, lignite or oil shale, other future technological breakthroughs, or by other competing fuels. It is probable that some natural gas transmission companies will be out of business in the future and that all of them will be forced by competition to expand into different areas of production. The electric industry, which is also affected by today's decision, has a more reliable and predictable future growth pattern largely because it

is vertically integrated. Hence, changes in production and transmission patterns can be more readily and flexibly absorbed by the distribution section of the industry. Here, too, however, the approaching competitiveness of nuclear fuel or other exotic patterns of generation may have such a financial impact that only financially sound companies will be able to take advantage of the large capital requirements necessary to participate in these new concepts. In addition, the spectre of onsite generation could introduce strong competitive factors even into the local distribution of electricity and necessitate entirely different concepts of electric utility service with possible large obsolescence of present day generation, transmission and distribution patterns.

In the light of recent utility history and of these facts, the policy of consistently employing every devise and every theory which seems likely to bring but a few pennies of relief to the ultimate ratepayer is utterly repugnant to fairness and common sense.

Proponents of mandatory flow-through must make certain assumptions in concluding that there is no risk of increased future taxes. I do not say that these assumptions are categorically false, but I do say that this case gives no certainty to these assumptions. They must be guessed and cannot be proven.

I, unlike the majority, do not have so much faith in my "clairvoyance" that I can totally ignore the past and be content to speculate about a future which may be replete with major technological breakthroughs in liquified natural gas, manufactured gas, solar cells, and other products and services which could change the very configuration of the industries which we regulate. It is one thing, once a company, with full knowledge of the facts, has decided to take the risks inherent in liberalized depreciation, to require it to flow the benefits through. It is quite another to force a company, against the informed judgment and

expertise of its management, to incur these risks. It is long past time for us as regulators to recognize that our regulatory responsibilities extend beyond the short run protection of the consumer. The protection of the long-range interests of the consumer is dependent upon the financial integrity of the public utilities which serve him. In this regard his interests are closely allied with those of the millions of people who have invested billions of dollars in public utilities, accepting a smaller return than would otherwise be possible because they seek greater security of investment. The investors deserve some protection too. The risk to both consumer and investor is too great, the stakes too high, to wave aside the very real danger they face in order to grant to only one of them what is, at best, a short-range benefit, and what may, in the long run, be no benefit at all.

The Examiners' decisions should be reversed, and the companies' reversion to straight-line depreciation should be approved.

CARL E. BAGGE
Commissioner

Opinion No. 497-A

OPINION AND ORDER DENYING APPLICATIONS FOR REHEARING AND EXTENDING TIME LIMITATIONS FOR FILING

(Issued September 9, 1966)

BLACK, Commissioner:

By its Opinion No. 497 and accompanying order issued July 15, 1966, in the above-entitled proceeding, the Commission ordered Midwestern Gas Transmission Company (Midwestern) and East Tennessee Natural Gas Company (East Tennessee) to file reduced rates effective January 1,

1967, to reflect reductions in their costs of service and revenue requirements resulting from the computation of Federal income taxes on the basis of liberalized depreciation tax deductions, even though both companies have reverted to the use of straight-line tax depreciation in their tax returns. The Commission also ordered Midwestern to make refunds for the period from October 13, 1964 through December 31, 1966. Applications for rehearing have been filed by both Midwestern and East Tennessee and by Natural Gas Pipeline Company of America (NGPL), the City of Chicago (Chicago), and the Independent Natural Gas Association of America (INGAA). In addition to their various allegations of error in the Opinion, Midwestern and East Tennessee have requested an extension in the time allowed therein for the filings required by our order.

Most of the arguments advanced in the applications for rehearing have been previously made and fully considered. In a number of instances the identical legal points were argued at greater length in the briefs and in the oral argument. Our re-examination of these arguments, and the many allegations of error addressed to other matters in the Opinion fully discussed therein, gives us no cause to depart from our basic determinations herein. A few of the matters raised in the applications may, however, benefit from a further discussion.

Both Midwestern and East Tennessee point out that a significant share of the rate reductions ordered by us stem from plant additions made in 1963 and thereafter as to which neither company has elected to apply liberalized depreciation. This is not relevant. It is clear that where we conclude that use of liberalized depreciation will result in a tax saving, this conclusion will apply to all eligible property whether or not the company has taken liberalized depreciation thereon. In the present case, the effect of such determination is made prospective insofar as East Ten-

nessee is concerned. Only Midwestern's voluntary adherence to a rate settlement expressly providing for retroactive treatment of the question precluded similar treatment in the case of Midwestern.

Midwestern contends that our *Alabama-Tennessee* opinion contemplated tax savings at a constant level and that it would require regular annual plant growth of over 4 percent (to prevent a decline in its net tax depreciable plant on which liberalized depreciation is computed) to produce such "true and continuing" tax savings. East Tennessee makes a similar argument. Both misconceive our *Alabama-Tennessee* opinion and our holdings here. Neither the *Alabama-Tennessee* opinion nor our opinion in these proceedings are premised on a conclusion that the annual amount of the tax saving will be constant or even that tax savings will be realized in each and every year. Instead both concluded only that a significant tax saving would result in the long run from the use of liberalized depreciation by a natural gas company maintaining at least a stable gross plant. The validity of our position is demonstrated by the very chart which Midwestern attaches to its rehearing application to make its point. For as this chart (Appendix C to the staff's initial brief) shows, in the case of Midwestern the use of liberalized depreciation will result in a significant *aggregate* tax savings over any full depreciation cycle under the 1.5 percent annual addition to gross plant situation there postulated.[1] The same would

[1] The calculations shown in Appendix A to Opinion No. 497 differ from those shown in Appendix C to staff's initial brief due to revisions in 1965 and 1966 additions based on 1965 actual additions and Midwestern's estimate of its 1966 additions. The projected additions shown in Appendix A to Opinion No. 497 for the period 1967-71 are lower than shown in Appendix C to staff's initial brief because of the smaller gross plant at December 31, 1966. Correction of the staff schedule using the same figures used in preparation of Appendix A of Opinion No. 497 shows a significant aggregate tax savings over the full depreciation cycle, and in no way supports Midwestern's argument that there is no tax saving.

be true (though the aggregate saving would be less) if the gross plant remained stable. The essential reason why this is true is that over the cycle there will be need for plant replacement. Of course, the extent of the saving will vary with the rate of growth. It is for this reason that we have elected to use the average savings over a five-year period. The companies are free at any time to re-examine the appropriateness of the level of savings computed from the use of liberalized depreciation and to take such action as is appropriate.

Midwestern observes that on page 32 of the mimeographed Opinion we incorrectly indicated that its decision to change from liberalized to straight-line depreciation came less than two weeks after the *Alabama-Tennessee* decision. As made clear in the chronogy shown on page 8, the statement should have read that its decision came less than two weeks after the initial decision in this case requiring liberalized depreciation.

Finally, Midwestern contends that we have erred in ordering a flow-through refund retroactive to October 13, 1964. We have read its argument with great care and can find no reason therein for changing or otherwise disturbing our resolution of the issue regarding the time of effectiveness of the reduction required by our decision, which we believe is required by the December 1964 settlement order.[2]

Chicago contends that we erred by understating the amount of the liberalized tax depreciation to be used in computing Midwestern's tax allowance for rate-making pur-

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[2] 32 FPC 1548. Although it appeared initially that Midwestern might be subjected to a tax expense under straight-line depreciation of some $2 million in excess of the tax allowance permitted in the cost of service for the period from October 13, 1964 through December 31, 1966, Midwestern has indicated in its application for rehearing (p. 32, footnote 36) that it has obtained conditional permission from the Internal Revenue Service to resume the use of liberalized tax depreciation effective January 1, 1966.

poses. It points out that the straight-line depreciation of $2,598,405 used in the settlement was a reduction of $342,500 from the depreciation allowance used in Opinion No. 444 and contends that it was incumbent upon us to use the settlement tax allowance in our computations.

This misses the point of the reduction in tax depreciation in the settlement. The tax depreciation agreed to by all parties (including Chicago) in the settlement was decreased from that established in Opinion No. 444 to reflect the lower tax depreciable base available to Midwestern on the property on which it had utilized liberalized depreciation during the years 1959 through 1962. Our action in Opinion No. 497 in restoring the reduction insures that both the company and its customers are in the identical circumstance as if the company had continued to take liberalized depreciation in accordance with its past practice. Thus, we have established the tax depreciation and the related revenue deduction on the assumed cost which would have been appropriate if straight-line depreciation had always been used as compared with the costs appropriate if liberalized depreciation had been continued. Our findings requiring Midwestern to make refunds and file tariff changes reflecting the use of liberalized depreciation tax deductions from October 13, 1964, precludes us from using a straight-line remaining life tax depreciation deduction which would have been the proper tax deduction had we allowed Midwestern to switch from liberalized to straight-line depreciation.

Disagreeing with our projection of a 4 percent annual growth rate, East Tennessee takes issue in its application with our calculation as to its past growth. It shows that its system sales were 51,192,893 Mcf in 1956 and 57,886,074 Mcf in 1965 for an annual growth rate of only 1.45 percent. The annual sales figures used in the Opinion of 17,371,000 Mcf in 1956 and 34,242,444 Mcf in 1965, equivalent to an average yearly increase of approximately 10 percent, were

only for jurisdictional sales as compared to the figures shown above for total system sales.[3] The statistics show that over the years East Tennessee has progressed from a system having 66 percent industrial sales and only 34 percent jurisdictional sales in 1956 to its 1965 position where 59 percent of its sales are made for resale and 41 percent are of an industrial nature. Considering the drastic reduction in purchases by East Tennessee's largest industrial customer resulting from the curtailment of activities at Oak Ridge,[4] East Tennessee has shown a remarkable ability to supplant lost sales with new customers when the need arises. The evidence shows that East Tennessee has a good potential for growth and that the growth of which it is capable actually has been experienced in the past years, particularly in the sales for resale category.

East Tennessee takes issue with our calculations in Appendix C to Opinion No. 497 regarding the annual reduction in its revenue requirements for the period to 1971 due to the use of liberalized depreciation deductions for tax purposes. The "adjustment for 1954-63 additions" is especially highlighted as erroneous. The figure used for the cited adjustment was based on testimony of record, the accuracy of which was not contested by East Tennessee in the proceeding. While we find no reason to change our projection of a 4 percent annual growth rate for East Tennessee, a growth rate which is conservative when compared to the 5-year and 15-year growth histories reflected in the Opinion, we believe that East Tennessee should be given an opportunity to submit, with suitable supporting material, any proposal for a revision in the calculations re-

[3] The same is true for peak-day sales wherein we have utilized jurisdictional peak sales and East Tennessee cites total system peak sales. Our conclusions are not affected thereby.

[4] East Tennessee's Form 2 report for the year 1954 shows sales of 25,593,357 Mcf to A.E.C., or more than 50 percent of total system sales. By 1965 this sale had declined to only 1,834,677 Mcf annually.

garding the 1954-1963 adjustment, as well as any recomputation of the $6,668,182 plant addition which we had assumed to be depreciable for the first time in 1965 but as to which we are now informed East Tennessee took depreciation on in 1964 on a straight-line basis.

As in the case of Midwestern, East Tennessee states in its application for rehearing that it has received permission from the Internal Revenue Service to revert to liberalized depreciation for the 1966 tax year upon the acceptance of certain conditions. As brought out in the Opinion, the only reason for not ordering the rate reduction prior to January 1, 1967, was our belief that, under Internal Revenue Service rulings, this was the earliest date possible for the reversion. Subject to the unspecified conditions attached by the Internal Revenue Service, the basis for the selection of the January 1, 1967 date may now have been vitiated. If so, and if East Tennessee does in fact file its final 1966 tax return using liberalized depreciation,[5] it should be required under the Opinion to flow-through the difference to its customers. This matter will be left open for the present pending the final determination of whether the 1966 taxes are computed on an accelerated or straight-line basis. A copy of the Internal Revenue Service ruling should be provided the Commission by East Tennessee.

The Applications for rehearing filed by NGPL and INGAA are, essentially restatements of their previous arguments. We find nothing in these filings requiring a detailed re-examination.

As noted above, both Midwestern and East Tennessee have asked for an extension in the filing requirements of the order accompanying Opinion No. 497. The time requested is 30 days after the order on rehearing. We be-

[5] East Tennessee states that "it does not intend to use liberalized depreciation in 1966 and in the future unless compelled to do so by an order of the Commission which becomes final."

lieve the time requested by Midwestern should be granted. As to East Tennessee, the company will be permitted a period of 30 days after Commission approval of any proposed revisions to Appendices C and D as may be forthcoming within which to submit the substitute tariff sheets required by our order.

The Commission further finds:

The assignments of error and grounds for rehearing set forth in the applications for rehearing filed by Natural Gas Pipeline Company of America on August 11, 1966, by East Tennessee Natural Gas Company and Midwestern Gas Transmission Company on August 12, 1966, and by the City of Chicago and the Independent Natural Gas Association of America on August 15, 1966, present no new facts or legal principles which would warrant any change or modification in the Commission's Opinion No. 497 and Order except as specified below.

The Commission orders:

(A) Not later than October 3, 1966, East Tennessee shall file any proposed revisions to Appendices C and D of Opinion No. 497 with the Commission for its approval. The revised calculation shall be prepared in accordance with the Opinion and shall reflect not less than a 4 percent average annual growth rate. Copies of any proposal so made also shall be served on the other parties to this proceeding. Any party wishing to comment thereon shall submit a statement to the Commission and the other parties not later than October 17, 1966.

(B) Final decision is reserved on the effective date of the use of the liberalized depreciation method in the computation of East Tennessee's tax costs for rate making purposes. In any event, such date shall not be prior to July 15, 1966.

(C) The time limitations specified in paragraphs (A) and (B) of the Order accompanying Opinion No. 497 are

extended with regard to Midwestern for a period of 30 days after the date of issuance of this order. With regard to East Tennessee, the time specified in paragraph (A) shall extend for a period of 30 days after Commission approval of any revisions to Appendices C and D accompanying Opinion No. 497.

(D) In all other respects, the applications for rehearing filed in this proceeding are denied.

By the Commission.

Commissioner O'Connor dissenting filed a separate statement appended hereto. Commissioner Bagge dissenting for the reasons set forth in his statement accompanying Opinion No. 497 issued July 15, 1966.

(SEAL)

GORDON M. GRANT,
Acting Secretary.

Docket Nos.
RP61-19 *et al.*

MIDWESTERN GAS TRANSMISSION COMPANY ET AL.

(Issued September 9, 1966)

O'CONNOR, Commissioner, dissenting:

I would grant rehearing for the reasons stated in my dissent to the initial opinion in the hope that in so doing the majority would more fully consider and reverse its erroneous decision. Since rehearing is not to be granted, there are two further issues upon which I am compelled to comment.

The majority states in its order denying rehearing (p. 2) that, "It is clear that where we conclude that use of liberalized depreciation will result in a tax saving, this conclusion will apply to *all eligible property* whether the company has taken liberalized depreciation thereon." (emphasis added). It is difficult to discern from this vague language whether

the majority is implying a repudiation of the *United* and *Wisconsin Michigan* cases wherein a unanimous Commission declined to force those companies to take liberalized depreciation. I should hope that no such implication is intended, but rather that those two opinions would remain unimpaired so that in the future, if the problems they represented are again directly before us, the Commission would adhere to the philosophy of those cases, and abide by their precedents. If, however, the Commission is repudiating those cases, then it is in fact taking the third step to which I referred in my dissenting statement (p. 1) regarding the forcing of a company never having utilized liberalized depreciation to do so. To this course, I would most vigorously dissent.

Through use of its plethora of recondite figures and a reliance on speculative projections and tables reflecting alleged "tax savings" to be realized as a result of using liberalized depreciation, the majority indicates that the companies will be paying less taxes under liberalized than straight-line depreciation. An example is to be found in footnote 9, p. 15, of the majority's opinion.

"The Statistics for Interstate National Gas Pipeline Companies reveal that $47,850,000 in deferred tax monies was accrued by all Class A and B pipelines in the year 1963. This amount, if flowed through to the consumers in 1963, would have resulted in an industry-wide rate reduction of approximately $100 million." It follows, therefore, that the reduced taxes which would have been payable to the Treasury will have to be made up in some other way and it takes very little imagination to figure who will ultimately bear the burden of making up the difference. In the regulated utility industry, the consumer and taxpayer are one and the same, a fact not dealt with by the majority. Consequently, the alleged "savings" are not so attractive as they might seem under the persuasion of the majority's opinion.

LAWRENCE J. O'CONNOR, JR.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1967—JANUARY SESSION, 1968

On Petition to Review Orders of the
Federal Power Commission

Nos. 15941, 15942 and 16017

MIDWESTERN GAS TRANSMISSION COMPANY, NATURAL GAS PIPELINE COMPANY OF AMERICA, EAST TENNESSEE NATURAL GAS COMPANY, *Petitoners*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA; CITY OF CHICAGO; AMERICAN PUBLIC GAS ASSOCIATION; ARTHUR ANDERSEN & Co., Intervenors in No. 15941,

KNOXVILLE, *et al.*, Intervenors in No. 16017.

January 5, 1968

Before HASTINGS, Chief Judge, and KILEY and CUMMINGS, *Circuit Judges*.

HASTINGS, Chief Judge. We have before us three petitions to review and set aside orders of the Federal Power Commission.

This proceeding was instituted by the filing of a petition in No. 15941 by Midwestern Gas Transmission Company (Midwestern) pursuant to Section 19(b) of the Natural Gas Act, 52 Stat. 831, 15 U.S.C.A. § 717r(b), for the purpose of reviewing and setting aside the Federal Power Commission's orders dated July 15, 1966 (Opinion 497), and September 9, 1966 (Opinion 497-A, denying rehearing of the July 15, 1966 order).

In No. 15942, the same orders were sought to be reviewed by Natural Gas Pipeline Company of America (Natural).

A petition to review the same orders was filed by East Tennessee Natural Gas Company (East Tennessee) in No. 17543 in the United States Court of Appeals for the Sixth Circuit. This was subsequently transferred to our court and has been docketed here as No. 16017.

It is undisputed that the three petitioners are each a natural-gas company within the meaning of the Act and that their rates for the sale of natural gas in interstate commerce for resale are subject to the jurisdiction of the Commission.

The Commission initiated investigations into the rates, charges or classifications of Midwestern for its southern and northern systems, respectively, by orders issued February 13, 1961, 25 FPC 275, and May 28, 1962, 27 FPC 1041. These were subsequently consolidated, 29 FPC 320.

The Commission subsequently instituted an investigation into the rate design of Natural by an order issued February 25, 1963, 29 FPC 399. This was consolidated with the Midwestern proceedings.

The Midwestern proceedings, except for the depreciation issue now before this court, and the question of rate design, were terminated by Commission Opinion No. 444, issued October 13, 1964. Opinion No. 444, at Midwestern's request, remanded the depreciation issue to the examiner to afford Midwestern an opportunity to show why it had changed to straight-line depreciation and how it would be adversely affected by utilizing liberalized depreciation, 32 FPC at 996.

Midwestern proposed a settlement agreement in connection with its application for a rehearing of Opinion No. 444, which was accepted by the Commission with modifications, 32 FPC 1548. Midwestern's settlement proposal in-

cluded its offer to refund to its ratepayers $3,569,600 in accumulated deferred taxes, which was accepted. Midwestern also proposed that further proceedings on the reserved depreciation issue be dismissed since it was no longer using liberalized depreciation. This part of the proposal, however, was rejected by the Commission, 32 FPC at 1549.

The rate design issues in Midwestern and Natural were determined by Commission Opinion No. 477, 32 FPC 973, and their rate designs were approved, 34 FPC at 984. The rate designs approved by Opinion No. 477 were challenged in this court by coal interests, but Opinion No. 477 was affirmed February 24, 1967, in *Fuels Research Council, Inc.* v. *Federal Power Commission,* 7 Cir., 374 F. 2d 842.

By its Opinion No. 456, 33 FPC 574, the Commission computed Natural's cost of service on the basis of federal income taxes resulting from Natural's use of liberalized depreciation. Natural filed a petition for review in the Court of Appeals for the District of Columbia. In *City of Chicago, et al.* v. *Public Service Commission,* No. 19604, and *Natural Gas Pipeline Company of America* v. *Federal Power Commission,* No. 19836, on September 8, 1967, the District of Columbia Circuit affirmed "the Commission's policy use of the 'flow through' of the current tax reduction resulting from the use of liberalized depreciation and its application of that policy in limitation of Natural's rate increase." . . . F. 2d . . . , at . . . . However, on one aspect of that case relating to a settlement agreement, with which we are not concerned here, the case was remanded for further proceedings.

The East Tennessee proceeding, with the exception of the depreciation issue, was determined by Commission Opinion No. 488, 35 FPC 534, issued April 19, 1966. The liberalized depreciation issue was severed and reserved for hearing together with Midwestern by the hearing examiner.

On February 3, 1964, prior to the issuance of Opinions Nos. 444 (Midwestern) and 488 (East Tennessee),[1] which left open the treatment of liberalized depreciation, the Commission issued its Opinion No. 417 in the case of Alabama-Tennessee Natural Gas Company. 31 FPC 208 (February 3, 1964); rehearing and stay denied, Opinion No. 417-A, 31 FPC 928 (April 15, 1964). On petition for review, this was affirmed in *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Com'n*, 5 Cir., 359 F. 2d 318 (1966), cert. denied, 385 U.S. 847.

Following hearings by an examiner and his resulting initial decision, the Commission heard oral argument *en banc* on the reserved tax depreciation in the consolidated Midwestern and East Tennessee cases. On July 15, 1966, the Commission issued its Opinion 497, now under review here, by a divided vote, 3 to 2, and ordered Midwestern and East Tennessee to file reduced rates to reflect the tax savings[2] resulting from liberalized depreciation even though the companies have discontinued liberalized depreciation in favor of straight-line depreciation.

In No. 15941, Independent Natural Gas Association was granted leave to intervene and W. P. Gilbert and Stephen L. Softenberg were granted leave to appear as amicus curiae, both on behalf of petitioners. City of Chicago and American Public Gas Association were granted leave to intervene on behalf of respondent.

In No. 16017, Knoxville Utilities Board and 23 others were granted leave to intervene on behalf of respondent.

We shall first interject at this point a summary of the depreciation practices used by Midwestern and East Tennessee.

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[1] Midwestern and East Tennessee are both subsidiaries of Tennessee Gas Transmission Co.

[2] Petitioners contend there can be no "tax savings" but rather only "tax deferrals" under their theory of this case.

Midwestern and East Tennessee, like Alabama-Tennessee, had been using the double declining balance method of liberalized depreciation prior to the Commission's *Alabama-Tennessee* decision on February 3, 1964. On April 29, 1964, the examiner issued his decision in the earlier Midwestern proceeding, following *Alabama-Tennessee,* and recommended that Midwestern's tax savings resulting from liberalized depreciation should be flowed through to the ratepayers. Twelve days later, on May 11, 1964, Midwestern's board of directors ordered that the company use a straight-line depreciation for tax purposes as of January 1, 1963. Before the end of the same year, by order of its board of directors, East Tennessee, which had been liberalized depreciation since 1954, converted to straight-line depreciation for its 1964 federal tax return.

As above stated, the Commission, by a divided vote, in its Opinion 497, (rehearing denied in its Opinion 497-A, September 9, 1966), determined the reserved tax depreciation issue adversely to Midwestern and East Tennessee, even though each petitioner had discontinued liberalized depreciation in favor of straight-line depreciation. This ruling by the Commission is before us in the instant case.

We have reviewed our prior determination of the approval of the rate design issues by this court in *Fuels Research,* 374 F. 2d 842, *supra,* and adhere to the views therein expressed.

We have made a thorough examination of Judge Wisdom's excellent research and learned consideration of the Commission's "about-face" order in *Alabama-Tennessee,* where the Fifth Circuit gave unqualified affirmance of the Commission's order, as reported at 359 F. 2d 318, *supra.* We need not further detail the exhaustive tratment of that opinion, but hold that we are in complete agreement with it.

Further, we have had occasion to review the scholarly opinion of Judge Leventhal for the District of Columbia

Circuit, in the petitions of City of Chicago and Natural, as reported at ... F. 2d ..., *supra*. That court, after awaiting the *Alabama-Tennessee* action by the Fifth Circuit, followed that opinion with approval and ruled, *inter alia*, adversely to Natural, as above indicated. We shall not further elaborate on that opinion, but express our complete approval of its holding on the "flow through" issue.

There are a variety of challenged issues presented by the numerous parties to this review.

Natural seeks an outright reversal of the prior decisions of the Fifth and District of Columbia Circuits in the foregoing decisions. Having already indicated our adherence to those cases, Natural's position is summarily rejected.

Most of the issues originally raised have been effectively settled by *Alabama-Tennessee* and *Natural*.

However, one basic distinction between the instant case and *Alabama-Tennessee* remains to be considered. The conversion to straight-line depreciation by Midwestern and East Tennessee, while their cases were pending, introduced an element not present in *Alabama-Tennessee*, which had continued to use liberalized depreciation.

Petitioners strenuously urge that their choice of straight-line tax depreciation was an act of managerial judgment, committed to the reasonable discretion of management, and that the Commission grossly erred in substituting its judgment for that of the boards of directors. Indeed, the strongly worded dissents by Commissioners O'Connor and Bagge lend persuasive comfort to the view that the majority grossly violated the basic concept that such matters lie entirely within the scope of managerial discretion.

However, on balance, we believe the action of the Commission in the situation before us, does not lend itself subject to the unsupported charge of being violative of an exclusive managerial decision. On the contrary, we have concluded that here the Commission cannot be required

to subordinate its own expertise to that of a claimed managerial judgment.

Except to the extent that Midwestern has agreed to adjustment as of a prior date, the impact of the Commission's determination would be prospective only. It has now been judicially determined that the use of the projected liberalized depreciation will result in tax savings for a number of years, rather than tax deferrals. It has been further adjudicated that it is valid to require flow through to consumers of the tax reductions achieved through the use of liberalized depreciation. The record sustains the view that petitioners have a growing or stable plant condition in the foreseeable future. It was further determined that the declining depreciation of older assets is offset by the increasing depreciation on new assets under the continuing use of liberalized depreciation, where at least some capital additions continue to be made, and will exceed straight-line depreciation. Certainly there is no credible support for concluding that the Commission was not reasonably warranted in making its favorable estimates of future plant growth for both petitioners.

We think it reasonable to understand that management's decision to revert to straight-line depreciation was to choose the one method certain to result in maximum tax costs to themselves, with resulting maximum rates to the consumers. The justification for this course by management is not convincing and therein lies the basic fault which leads to the conclusion that managerial discretion has exceeded its reasonable course and compels the intrusion of regulatory intervention.

We freely recognize, as does the Commission, that there are many areas and many situations which must remain within the jurisdiction of management. However, it has long been recognized that establishment of public utility charges involves the assessment of costs for a public service. Basic to the purpose of the Natural Gas Act is a design of regulation concerned with final adoption of rate

charges fairly intended to protect the public interest. Necessarily, the area of tax policies embraces managerial decisions directly reflected in the cost of natural gas supplies for the use of the ultimate customer. Here it seems to us quite reasonable and logical to recognize as inherent in the Commission the duty and requirement to exercise its expertise in evaluating the entire tax effect of managerial judgment. If such elected tax policies do not fairly indicate a reasonable and prudent business expense, which the consuming public may reasonably be required to bear, following the required hearing and review procedures, then federal regulatory intervention is required.

We conclude, therefore, that under the circumstances found present here, the decision of petitioners to abandon the liberalized method of depreciation in favor of the straight-line method, furnishes no material variance to distinguish the result found here from that reached in the cited cases. The determination of the Commission, though hotly disputed by its own minority, is supported by the record and will be affirmed.

In our judgment, the rates found and the conclusions reached by the Commission, are adequately supported by the record.

The other distinguishing factor hereinabove referred to, between the present case and *Alabama-Tennessee,* is the fact that Midwestern voluntarily refunded to its ratepayers its deferred tax reserve it had accumulated in the sum of $3,569,600. We understand that this sum represented the difference between the federal income taxes actually paid by Midwestern on the basis of liberalized depreciation and the greater amounts included for income taxes in its cost of service on the basis of normalization. The ratepayers paid a somewhat larger amount to cover the taxes on the difference.

Although not required by *Alabama-Tennessee* to do so, Midwestern chose to refund this reserve, thereby gaining a tax saving of about $1,700,000, which it was not required

to reflect in reduced rates. This matter was eventually resolved through a settlement agreement which was modified and then was finally approved as modified to provide that the adjustment, if any, to Midwestern's rates to reflect the Commission's final disposition of the reserved issue, shall be effective as of October 13, 1964.

We conclude that the settlement agreement properly reflects the agreement of all parties and that, as to Midwestern, the Commission correctly determined the effective date to be October 13, 1964, rather than to make it prospective only as was the case with East Tennessee.

Enough has been said and determined by the decisions of the Fifth and District of Columbia Circuits to adequately dispose of other questions raised. We have carefully considered the many contentions and authorities cited by all parties, intervenors and amicus curiae and have found no reason to change our view of affirmance. The record amply supports the Commission's findings.

We have considered the request of the Commission to dismiss Natural from these proceedings for want of aggrievement. While we consider that the District of Columbia Circuit decision rather effectively disposed of Natural and we find nothing persuasive in Natural's argument here, Natural was admitted originally on its petition to review in No. 15942, and we shall not disturb its present posture.

The petitions for review and to set aside orders of the Federal Power Commission are each denied and the orders of the Federal Power Commission under review are in all respects affirmed.

PETITIONS DENIED
ORDERS AFFIRMED.

A true Copy:
Teste:

.....
Clerk of the United States Court of Appeals for the Seventh Circuit.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

Friday, January 5, 1968

Before: Hon. JOHN S. HASTINGS, *Chief Judge;* Hon. ROGER J. KILEY, *Circuit Judge;* Hon. WALTER J. CUMMINGS, *Circuit Judge*

Nos. 15941, 15942, 16017

Petitions to Review orders of the
Federal Power Commission

MIDWESTERN GAS TRANSMISSION COMPANY, NATURAL GAS PIPELINE COMPANY OF AMERICA, EAST TENNESSEE NATURAL GAS COMPANY, *Petitioners,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA, *et al.,*
Intervenors in No. 15941

KNOXVILLE UTILITIES BOARD, *et al.,*
Intervenors in No. 16017

This cause came on to be heard on petitions to review and set aside orders of the Federal Power Commission, and the record from the Federal Power Commission, and was argued by counsel.

On consideration whereof, it is ordered by this Court that the petitions to review and set aside the orders of the Federal Power Commission entered in this cause on July 15, 1966 and September 9, 1966, be, and the same are each hereby DENIED, and the said orders are in all respects AFFIRMED in accordance with the opinion of this Court filed this day.

A True Copy:
Teste:

KENNETH J. CARRICK
Clerk of the United States Court of Appeals for the Seventh Circuit

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

Wednesday, February 7, 1968

Before: Hon. JOHN S. HASTINGS, *Chief Judge;* Hon. ROGER J. KILEY, *Circuit Judge;* Hon. WALTER J. CUMMINGS, *Circuit Judge*

Nos. 15941, 15942 & 16017

Petition for Review of an Order from the Federal Power Commission

MIDWESTERN GAS TRANSMISSION CO., *et al., Petitioners,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

IT IS ORDERED by the Court that the joint petition for rehearing filed in the above entitled cause be and the same is hereby denied.

The Natural Gas Act

Sec. 5.(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

Internal Revenue Code 1954

§ 167. *Depreciation*

(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) Use of certain methods and rates.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).